Policy Matters

Flat Taxes, Dual Taxes, Smart Taxes: Making the Best Choices

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Introduction

With mounting budgetary surpluses and growing acceptance of the need to improve the economy's performance, the need for tax cuts has risen to the top of the policy and political agendas in Canada. The most sweeping tax proposals have come from the Canadian Alliance, with a flat tax plan launched early in 2000 (under the Reform Party banner). Subsequently, the Progressive Conservatives also offered extensive plans for tax cuts in the report of their Task Force on Taxation. A federal budget ensued in February that made more modest pledges for tax cuts over the next five years.[1] In October, the Alliance shifted its tax plan to a dual rate scheme. The federal government quickly followed with major tax cuts in a mini-budget, a response both to increasing surpluses and the political competition around tax policy. All these tax and related fiscal plans have raised basic questions about the best way to cut personal and business taxes and what tax reforms should complement the rate cuts. This study examines the key tax policy issues via a detailed evaluation of the Alliance proposals. Because the study was completed prior to the mini-budget's tax changes, these could only be assessed briefly in an addendum. Whether the Liberal or Alliance tax plan continue to dominate the next Parliament, this study contributes to the broader debate around tax reform.

A 17 percent flat tax plan, modified to a transitional dual rate tax plan with the 17 percent rate still covering almost all taxpayers, is part of the Canadian Alliance economic platform.[2] The party's former finance critic described the plan as "the first major policy plank of our new political party."[3] This proposal is unquestionably bold, but is either form of tax good economic policy? Is it good social policy? Does the shift from a single rate to a dual rate tax fundamentally alter the original policy? Would the plan achieve its promised gains to economic efficiency, incentives, and growth at a cost that is acceptable in terms of equity or social justice? And are there superior alternatives that could deliver the same or greater economic benefits with less social costs? The flat and dual tax plans do engage important issues of economic and social policy, and the switch to a dual rate does bring the plan closer to the mainstream of Canadian tax policy discourse. This study proposes an alternative tax policy that would involve significant but lesser rate cuts, and more extensive base reforms, than the Alliance scheme.

The original Alliance plan was called a "single rate tax" rather than a flat tax. One of the "Frequently Asked Questions on Solution 17" on the party's website asks, "Isn't this just like the American flat tax idea?"[4] The response is that, while a flat tax removes all deductions, this tax would retain all currently allowed deductions (and even expand some). The answer goes on to say

that this tax plan would remain "progressive" in the sense that average tax rates would rise with individual incomes. However, all the American flat tax schemes also provide enlarged personal exemptions and therefore are progressive in the same way. Many of them also retain some other deductions, albeit reduced from existing levels. As there is nothing to differentiate the Canadian Alliance plan from many previous flat tax plans, we shall adopt the "flat tax" label for the Alliance proposal.[5] The modified plan, which is called a "fair tax plan" in the party's electoral platform, is a form more commonly called a dual rate tax. For brevity, it will be called a "dual tax" in this study. The flat tax plan also warrants close examination here, both because of its similarities to the dual tax plan and because it remains the stated goal of the Canadian Alliance tax policy.[6]

This study examines key issues needed to assess the economic and social policy implications of various tax reduction plans. It first compares Canadian and US personal tax rates in various dimensions; this permits an objective evaluation of commonly made assertions about Canadian tax rates and how they depart from US rates.[7] Next, the issue of rate progressivity is investigated in the context of claims that have been made about the flat and dual tax plans. A related issue is the jurisdictional level at which progressive rate structures are economically appropriate. The relations between tax structures and equitable family taxation are examined next, followed by a review of the extent to which a flat or dual rate tax would simplify the personal tax system. The analysis then turns to the economic criteria of efficiency, incentives, and growth and to the nature of tax rates and base reforms that would best achieve these three objectives. Two additional issues are the implications of the flat and dual tax plans for tax revenues and public spending — each with its own efficiency and equity effects — and other tax changes that would best accompany such tax schemes. Finally, the study presents an alternative approach to the flat and dual tax plans, a comparison with the tax proposals of other political parties, and a summary of principal findings.[8]

In assessing these issues, one should begin with a clear view of the goals of taxation policy. A tax system must generate the revenues needed to finance the chosen public purposes. It should extract these funds in a manner that imposes the least deterrent to individual incentives, the efficient use of resources, and the economy's growth. It should operate in as simple a manner as possible, minimizing the need for tax planning and leaving little room for tax avoidance, but giving due consideration to various equity goals. And its burdens should be spread across those at different income levels and in differing circumstances in a pattern that the public deems to be fair. These three key criteria for taxes — effi-

ciency, simplicity, and equity — are as relevant to tax analysis today as they were when first formulated by Adam Smith over 200 years ago. Of course, conflicts frequently arise in achieving the various goals of tax policy, requiring delicate compromises among them.

To assess particular tax provisions or proposals using these criteria, one must use a mix of objective economic analysis and personal value judgments. Personal values are central in considering the desired distribution of the tax burden across income classes, while economic analysis is needed to assess the efficiency implications. Personal values are also critical when judging issues of tax equity across various groups, such as the different types of family units. And personal values will enter into determining how large total tax revenues and government spending should be; this involves balancing the value of private consumption against the value placed on publicly consumed goods and services. Nevertheless, economic analysis is useful both to show the true cost of raising tax revenues and to quantify the trade-offs among various goals and values. Personal values have a necessary role in choosing tax policies, but careful economic analysis can inform the range of tractable choices.

Competing with US Tax Rates

A major theme driving the various tax reduction proposals is that Canadian personal income taxes are no longer competitive with those in the US. The Minister of Finance has stressed that the government's first priority for tax cuts is personal income taxes. Reasons commonly cited for this emphasis are the brain drain to the US, the need for productivity-enhancing investments, and the retention and generation of productive firms and jobs.[9] There has also been widespread acceptance of several assertions about the relative status of Canadian and US income taxes:

- Canada is unique in its heavy reliance on income taxes vis-à-vis both the US and other countries.
- Income tax burdens on average are much higher in Canada than in the US.
- Top marginal tax rates (MTRs) are substantially higher in Canada than in the US.
- Top MTRs are applied at much lower income levels in Canada than in the US.
- Relatively high MTRs are applied at much lower incomes in Canada than in the US.

This section compares the personal tax levels and MTRs for Canada and the US; the MTRs are particularly relevant for most incentive and efficiency effects of taxes.[10] Each of the above assertions is examined using relevant evidence; some are fully or partially rejected. The comparisons are found to turn importantly on the division between federal and state/provincial income taxes. At the federal level, marginal tax rates rise to much higher levels in the US than in Canada. However, this is partially or fully offset by the much heavier reliance on income taxes by the Canadian provinces than by the American states. The relatively heavier income taxes at the federal vis-à-vis the state/provincial level in the US compared with Canada stem from a different balance in jurisdictional spending burdens in the two countries as well as the lack of an American national sales-type tax. In 1999, the federal government in the US accounted for 58 percent of all public expenditures; the figure in Canada was just 35 percent. If transfers to other levels of government are included, the figures become 67 percent for the US versus 43 percent for Canada.[11] It is hardly surprising that US federal taxes in total must be relatively more burdensome than Canadian federal taxes, even if the total US tax burden is lower than that in Canada.

Table 1
Mix and Level of Tax Revenues, Canada and US, 1997

	Tax as % of total taxes		Tax as % of GDP	
Type of tax	**Canada**	**US**	**Canada**	**US**
Personal income	38.0	39.0	14.0	11.6
Corporate income	10.3	9.4	3.8	2.8
Payroll[a]	15.5	24.2	5.7	7.2
Goods and services[b]	24.4	16.7	9.0	4.9
Property[c]	10.0	10.7	3.7	3.2
Total[d]	100.0	100.0	36.8	29.7

Notes:
[a] Includes social security contributions as well as general payroll taxes
[b] Includes general sales taxes (retail taxes, GST) as well as excise taxes
[c] Includes taxes on wealth and estates as well as real estate
[d] Totals do not always agree because of rounding error and minor omitted tax types

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965/1998* (Paris: OECD, 1999).

Tax revenues and tax mix

In terms of the mix of revenues across various taxes, Canada and the US rely on personal income taxes to almost the same degree. As shown in Table 1, the US obtains slightly more (39 percent) of its total revenues from this source than does Canada (38 percent).[12] Despite this close similarity, the personal tax burden is still heavier in Canada than in the US because the total Canadian tax burden is larger relative to GDP, 37 percent versus 30 percent in the US. Hence, Canadian personal income taxes take 14.0 percent of GDP, compared with 11.6 percent for the US. This makes personal taxes on average 20 percent more burdensome for Canadians than for Americans. Canadian income taxes are the heaviest of the major economies (the G-7) but are exceeded by Nordic countries such as Denmark (25.9 percent of GDP), Finland (15.5 percent), and Sweden (18.2 percent) as well as Belgium (14.3 percent) and New Zealand (15.7 percent).[13]

Canada's overall tax mix is also quite similar to that of the US in economically meaningful dimensions. Corporate income taxes make up 10.3 percent of total taxes in Canada versus 9.4 percent in the US. Thus personal plus corporate income taxes make up virtually the same 48 percent of total taxes in both countries. Two major types of taxes — payroll taxes and taxes on goods and services (retail sales taxes, excise taxes, and the GST) — affect only labour income and consumption, but not capital income or savings. Because these two types of taxes do not distort savings or investment decisions, or capital markets, they behave quite similarly in terms of their effects on the economy. Canada and the US each rely to almost the same degree on these taxes taken together, about 40 percent of total tax revenues. However, Canada is much more reliant on the sales-type taxes (since the US has no general sales tax at the federal level), whereas the US leans much more heavily on payroll taxes.

Federal personal income tax schedules

To begin the comparison between US and Canadian federal personal income taxes, let us consider their taxable threshold levels. This is the lowest level of income at which an individual or filer becomes taxable. In terms of competitive pressures (domestic or international) on the Canadian tax system, this issue is relatively unimportant. But in terms of social policy and distributional effects of the tax system, it is of considerable interest. To compare taxable thresholds of the US and Canada in a meaningful way, one needs to take the purchasing-power-parity (PPP) measure of US dollar figures. This is simply how much a US dollar would purchase in Canada in terms of an average person's consumption bundle. By this measure, the Canadian dollar is sharply

undervalued on the exchange markets, as its recent PPP value is 84 cents US per dollar or more than 25 percent above recent market exchange rates.[14] Using this metric, taxable thresholds are lower in Canada than the US, and using market exchange rates would sharpen the differences. For example, for a non-aged single person, the Canadian threshold in 2000 is $7,365, whereas the US threshold at PPP is $8,571.[15] To compare the effective taxable thresholds for families with children one would need to take into account various refundable credits in both countries — the Child Tax Benefit (CTB)[16] and GST credits in Canada, and the Earned Income Tax Credits (EITC)[17] (along with both personal exemptions and non-refundable tax credits for children) in the US. Considering all factors, most types of family units become taxable at lower incomes in Canada than the US.

We next compare the income tax rate structures for the US and Canada at the federal level for the 2000 tax year (Table 2). The US offers four separate rate schedules by type of filer (singles, heads of household, and married couples filing either joint or separate returns).[18] The bottom-bracket rate in the US is just 15 percent, but this jumps quickly to a second-bracket rate of 28 percent, which is near the top fed-

Table 2
US and Canadian Federal Personal Income Tax Schedules, 2000

US federal PIT					Canada federal PIT	
Marginal tax rates (%)	Income thresholds by filer type, US$				Marginal tax rates (%)	Income thresholds C$
	Single	Head of household	Married filing joint returns	Married filing separately		
15	0	0	0	0	17	0
28	26,250	35,150	43,850	21,925	25[a]	30,004
31	63,550	90,800	105,950	52,975	29	60,009
36	132,600	147,050	161,450	80,725	30.45	75,000[b]
39.6	288,350	288,350	288,350	144,175		

Notes:
[a] The 26 percent rate middle tax bracket was reduced to 24 percent in the middle of the 2000 tax year, so that the average rate of 25 percent is applied for the full year.
[b] In 2000 the surtax rate of 5 percent of tax above a threshold affects taxpayers with incomes above around $75,000. In 1999, the effective level was around $65,000.
Source: US schedules from TaxPlanet website www.taxplanet.com; Canadian schedules from Canada Department of Finance, *Budget 2000 — Budget Plan*, Ottawa, February 28, 2000.

eral MTR in Canada of 29 percent (before surtax). The point at which the US federal MTR rises to 28 percent hinges on the filer type, ranging from US$26,250 for singles to US$43,850 for married joint filers. For married persons filing separate returns, the figure is even lower than for single filers, at just US$21,925, although it is higher at US$35,150 for household heads. Note that this jump between first- and second-bracket MTRs is a sharp 13 percentage points in the US federal tax, larger than the corresponding 8 percentage point jump in Canada for 2000.

The next US federal tax bracket has a MTR of 31 percent, which actually exceeds the highest federal MTR of 30.45 percent including surtax in Canada. This bracket arises for incomes above US$63,550 for singles and US$105,950 for married joint filers. In contrast, the top Canadian federal MTR (excluding the surtax) arises at just over $60,000 for a single adult and just over $120,000 for a married couple with equal incomes. Including the federal surtax, the top total MTR in Canada arises at about $75,000 for singles and $150,000 for married taxpayers (with equal incomes). The comparisons made between US and Canadian income tax rates often ignore the fact that married couples can file jointly in the US but must file separate returns in Canada (for incomes exceeding the taxable thresholds). Hence, the relevant income ranges for Canadian tax rates on married persons are much larger than the statutory tax brackets, as much as double in the case of partners with equal incomes. A proper comparison would be the US tax brackets for married persons filing separate returns; for such filers, the 28 percent rate bracket starts at just US$21,925, and the 31 percent rate starts at US$52,975 of individual income.

The top MTR in the Canadian federal income tax is 30.45 percent, while the US rates rise still further at very high income levels. The sweeping US Tax Reform Act of 1986 sharply reduced the top federal tax rate of 50 percent and collapsed the rate structure to just two brackets — 15 and 28 percent. A 31 percent rate bracket was added at higher incomes in a 1990 deficit-reduction budget compromise by a Democrat-controlled Congress and President George "Read My Lips — No More Taxes" Bush. As of 1992, the top 31 percent rate was applied for incomes above US$51,900 and US$86,500 for single and married joint filers, respectively. Two more brackets of 36 and 39.6 percent were added for still-higher incomes in President Clinton's deficit-reduction package of 1993 (see Table 2 for the current bracket levels). Additionally, in 1993, the upper earnings limit for the Social Security medicare payroll tax was removed, adding another 1.45 and 2.9 percent to total top MTRs for employment and self-employed earnings, respectively. While it is often mentioned that top US MTRs arise only at much higher incomes than in Canada, this observation ignores the fact that these top MTRs at the federal level are also much higher than in Canada.

Table 3
US State Personal Income Taxes by Top Marginal Tax Rate, 2000

Top MTR (%)	States
zero (no state tax)	Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming
interest/dividends only[a]	New Hampshire, Tennessee
2.8 – 3.99	Illinois*, Indiana*, Pennsylvania*
4.0 – 4.99	Colorado*, Connecticut, Maryland, Michigan*
5.0 – 5.99	Alabama, Arizona, Delaware, Massachusetts*, Mississippi, Virginia
6.0 – 6.99	Georgia, Kansas, Kentucky, Louisiana, Missouri Nebraska, New Jersey, New York, Oklahoma[b], Wisconsin, West Virginia
7.0 – 7.99	Arkansas, North Carolina, Ohio, South Carolina Utah
8.0 – 8.99	Hawaii, Idaho, Iowa, Maine, Minnesota New Mexico
9.0 – 9.99	California, Oregon, Vermont[c]
10.0 – 10.99	Rhode Island[d]
11.0 +	Montana, North Dakota[e]

Notes:
*Flat rate tax
[a]Personal tax applies to interest and dividend incomes only
[b]Separate schedules, with rates ranging up to 10 percent, apply to taxpayers deducting federal income taxes
[c]24 percent of federal tax liability
[d]26 percent of federal tax liability
[e]Taxpayers have the option of paying 14 percent of adjusted federal income tax liability, without a deduction of federal taxes

Source: The Federation of Tax Administrators, webpage *http://www.taxadmin.org/fta/rate/ind_inc.html*, July 10, 2000.

As noted, US federal MTRs exceed the top Canadian federal MTRs at much lower, albeit upper-middle, income levels.

State and provincial marginal tax rates

We now turn to comparative personal income tax rates at the American state and Canadian provincial levels. Table 3 shows the top MTRs for the 50

states; not shown in the table are the many cities and counties that also apply income or payroll-type taxes to employment earnings within their boundaries. Seven states do not apply a personal income tax (of which the only populous ones are Florida and Texas); two other states apply a tax only to interest and dividend incomes. The remaining 41 states have general income taxes with top MTRs that range from just 2.8 percent to over 11 percent. Six of the states apply a flat rate of tax above an exemption level, and all of these are among the lower-tax states. The rest of the taxing states employ progressive rate schedules, but without exception they apply their top MTRs at much lower incomes than the threshold used for the federal top MTR. The median top MTR for the states is in the 6 to 7 percent range. California is the most populous state with a high top MTR, at 9 percent.

Table 4
Canadian Provincial Income Taxes, Top Marginal Tax Rates, 2000

Top MTR (%)	Province	Comments
13.3	Alberta	Tax on tax (includes flat tax); will move to tax on income in 2001 (flat rate of 10.5 percent)
17.4	Ontario	Tax on income (includes high income surtaxes)
17.6	Manitoba	Tax on tax (includes flat tax and surtax); will move to tax on income in 2001
18.3	Nova Scotia	Tax on income
18.3	PEI	Tax on tax; will move to tax on income in 2001
18.4	New Brunswick	Tax on income
19.3	Saskatchewan	Tax on tax (includes flat tax and surtax); will move to tax on income in 2001
20.9	Newfoundland	Tax on tax; will move to tax on income in 2001
20.9	British Columbia	Tax on income (includes high income surtaxes); total MTR of 49.9 percent for 2001
25.0	Quebec[a]	Tax on income; province operates own tax and obtains lower federal income tax rates (abatement)

Note: [a]After adjusting for the abatement of federal tax to Quebec taxpayers, the effective top MTR for Quebec is 20.2 percent.

Source: Author's calculations using the relevant tax rate schedules.

The top MTRs for each Canadian province appear in Table 4, with a range from 13.3 percent for Alberta to 20.9 percent for British Columbia and Newfoundland. The still-higher 25.0 percent for Quebec reflects reduced federal tax rates for taxpayers in that province as an offset for special spending arrangements. In 2001, Alberta will cut its top MTR further with the introduction of a flat tax at a 10.5 percent rate. Even at that rate, which will be the lowest top MTR of all the Canadian provinces, Alberta will just be on par with Rhode Island, Montana, and North Dakota – the three American states having the highest top MTRs. In general, Canadian provincial personal income taxes are much heavier than counterpart American state taxes, not only at the highest but at most income levels. Canadian provincial taxes have typically ranged from around 45 to 60 percent of the individual taxpayer's federal income tax liability. With the switch from a "tax-on-tax" regime to a "tax-on-income" regime, where the province applies its own tax rate schedule to federally defined taxable income (except for Quebec), one might expect to see greater provincial variation in both top and lower MTRs. Several provinces have already moved to a tax-on-income system for 2000, with the rest to follow in 2001. Saskatchewan is using this opportunity to substantially cut its top MTR, from a current 19.3 percent to 15.0 percent by 2003 (on taxable incomes above $100,000).[19]

One can add together the top MTRs applied at the federal and state/provincial levels in each country to compare the overall top MTRs. Table 5 presents the results of such an exercise for representative low- and high-tax states and provinces, giving the top MTRs separately for major income types.[20] The impact of various tax and benefit phase-out provisions (such as the EITC and phase-out of personal exemptions at high incomes in the US, and the CTB in Canada) is ignored in these figures. For any of the US states without an income tax, the federal-only figures are the relevant total top MTRs. Illinois is chosen to represent the states with low but positive income taxes; California for the states with relatively high income taxes. On the Canadian side, figures are presented for the four most populous provinces, Alberta, British Columbia, Ontario, and Quebec. The Alberta figures use the province's 2001 flat tax regime to show the effects of this major change; all other figures in the table are for the 2000 tax year. The calculations of top MTRs reflect the tax provisions that apply to particular types of incomes — such as the dividend tax credit in Canada, payroll taxes for medicare on all labour earnings in the US, and special tax rates for capital gains in both countries.

As shown in Table 5, the top MTRs for even a given jurisdiction vary considerably across the income types. For the US federal tax, these rates range

Table 5
Top Marginal Tax Rates by Type of Income, US and Canada federal and state/province, 2000

	US Top MTR (%)			Canada Top MTR (%)				
Type of income	Federal only	Federal plus IL[d]	Federal plus CA[d]	Federal only[e]	Federal plus AB[h]	Federal plus BC	Federal plus ON	Federal plus QC
Labour income								
Employment	41.1[a]	44.1	50.4	30.5	41.0	51.3	47.9	50.7
Self-employment	42.5[b]	45.5	51.8	30.5	41.0	51.3	47.9	50.7
Capital income								
Interest	39.6	42.6	48.9	30.5	41.0	51.3	47.9	50.7
Dividends	39.6	42.6	48.9	21.4[f]	26.5	32.2	31.3	35.0
Short-term capital gains	39.6	42.6	48.9	20.3[g]	27.3	34.2	31.9	33.8
Long-term capital gains	20.0[c]	23.0	29.3	20.3[g]	27.3	34.2	31.9	33.8

Notes:
[a] Includes Social Security medicare employee payroll tax of 1.45 percent (as do the state-inclusive figures)
[b] Includes Social Security medicare self-employed payroll tax of 2.9 percent (as do the state-inclusive figures)
[c] Assets held more than one year (excludes collectibles and depreciable business assets)
[d] Ignores itemized deduction of state income tax in federal income tax, which could reduce effective MTR by up to 1.2 percent in Illinois and up to 3.7 percent in California if the filer is not constrained by the high-income limit on certain itemized deductions or the alternative minimum tax
[e] Includes federal top-bracket rate of 29 percent plus federal surtax of 5 percent of tax above high-income threshold (1.05 x 29 percent)
[f] Dividends received from taxable Canadian corporations, eligible for dividend tax credit (similarly for the provincial-inclusive figures)
[g] For Canada, rates are for capital gains realized after the federal budget of 2000 (February 27), which reduced the inclusion rate from three-fourths to two-thirds (similarly for the provincial-inclusive figures)
[h] Figures presented for Alberta flat tax of 10.5 percent to be implemented in 2001 but top federal tax rate for 2000 (with 5 percent high-income surtax); in 2000 the top MTR for federal plus Alberta is 43.8 percent for labour and interest incomes.

from 42.5 percent for self-employment income (including the Social Security medicare tax) to 20.0 percent for long-term capital gains.[21] For the Canadian federal tax, these rates range from 30.5 percent for labour income to 20.3 percent for capital gains (both short- and long-term). Comparing US and Canadian top federal MTRs by type of income, the Canadian rates undercut the American rates substantially for all income types except long-term capital gains (which are just 0.3 percent higher in Canada).[22] Alberta with its flat tax in 2001 will undercut even a low-tax state such as Illinois for top MTRs except on long-term capital gains, and it will even be on par with or below the rates in states without an income tax (see the "US federal only" column), again excepting long-term capital gains. Turning next to the high-tax jurisdictions, BC and Quebec are fully competitive with California in top MTRs with respect to labour incomes, a bit higher on interest incomes, much lower on dividends and short-term capital gains, and higher on long-term capital gains. If there is any issue involving Canada's competitiveness with top MTRs in the US, it arises solely with respect to long-term capital gains.

Marginal tax rates by income level

Of course, the overwhelming majority of taxpayers in both countries do not face the top MTR, so the pattern of tax rates across the full income spectrum is relevant when comparing their taxes. We next examine the pattern of MTRs by income level for the US and Canada by taking a large jurisdiction in each country with representative tax rates (New York and Ontario). Before looking at the resulting figures, we note several aspects of this comparison. Ontario has below-average tax rates at low and moderate incomes but applies sharp surtaxes beginning around $55,000, so its top provincial MTR is not atypical. For New York, we take only the state-level income tax and ignore the New York City tax, which applies up to an additional 3.83 percent rate. Like many other states, New York's tax is quite flat, hitting its top MTR of 6.85 percent at income levels where individuals are still in the bottom bracket of the US federal income tax. American figures have been converted into Canadian dollars using the PPP exchange rate of 84 cents US per Canadian dollar; using recent market exchange rates would only accentuate the findings. These differences would also be increased by considering the more generous deductions and exclusions available to US taxfilers (mortgage interest, property taxes, state income taxes, tax-free state and municipal bond interest, and half of social security receipts above a threshold).[23]

All our examples take non-aged taxpayers with no children, to avoid the complicating effects on MTRs of various seniors' and child-related tax credit and

benefit provisions.[24] The analysis assumes that all income is from employment earnings, the dominant source of income for almost all income groups among the non-aged. Hence, we also consider the impact of employee payroll taxes on total MTRs, with the offsetting tax credits for these payments in Canada; the US does not offer deductions or credits for employee payroll taxes. One reason for the surprisingly high total MTRs in the US at upper-middle incomes is that the high payroll tax rates apply up to US$76,200 of annual earnings (and over US$150,000 for two-earner couples). The analysis for two-earner couples assumes that total earnings are divided equally between the spouses; any differential division of earnings would yield results intermediate between the plotted one-earner and two-earner figures.

Figures 1 to 3 show the situation for single taxpayers, one-earner couples, and two-earner couples, respectively. As seen in Figure 1, single persons with incomes up to $60,000 face MTRs that are sometimes higher and sometimes lower in Canada than the US. The falling pattern of the Canadian MTRs in the upper $30,000 range reflects the earnings ceilings for Employment Insurance (EI) and Canada Pension Plan (CPP) payroll taxes. From the low $60,000s to higher earnings, the Canadian MTR is consistently, and often significantly, above the counterpart US rates. The only exception is for incomes facing the top US MTR, above roughly $350,000, where the two rates are virtually identical — 47.86 percent in Ontario and 47.90 percent in New York.

The one-earner married couple, in Figure 2, faces MTRs in Canada that are consistently and often significantly above MTRs in the US for all incomes from the taxable threshold (about $13,700) up to the highest incomes except where the US attains its top MTR equal to the top MTR in Canada. Figure 3 presents the corresponding patterns for two-earner married couples in the two countries; these results differ dramatically from those for the one-earner married couples. The MTRs in this case are very competitive with those in the US for incomes up to the low $60,000s. For all incomes between the upper $60,000s and $120,000, the MTRs are now significantly lower in Canada than the US; this is the income range where each spouse earns between $30,000 and $60,000. For total income above $120,000, this pattern reverses, with the Canadian two-earner couples facing the higher MTRs. The contrast of this pattern vis-à-vis the one-earner married couple stems from three factors: (1) in Canada, the tax brackets are in effect twice as wide as those for a single filer, since each spouse files a separate return; (2) in the US, married partners file a joint return but the tax brackets are not fully twice as wide as those for singles to account for scale economies;[25] and (3) with two earners, the relatively high US payroll taxes apply to twice as much total earnings, with the full 7.65 percent rate striking more than US$150,000.

Figure 1
Total MTRs (income tax & payroll tax) in Ontario and New York, 2000, single taxpayer with no children, all employment income

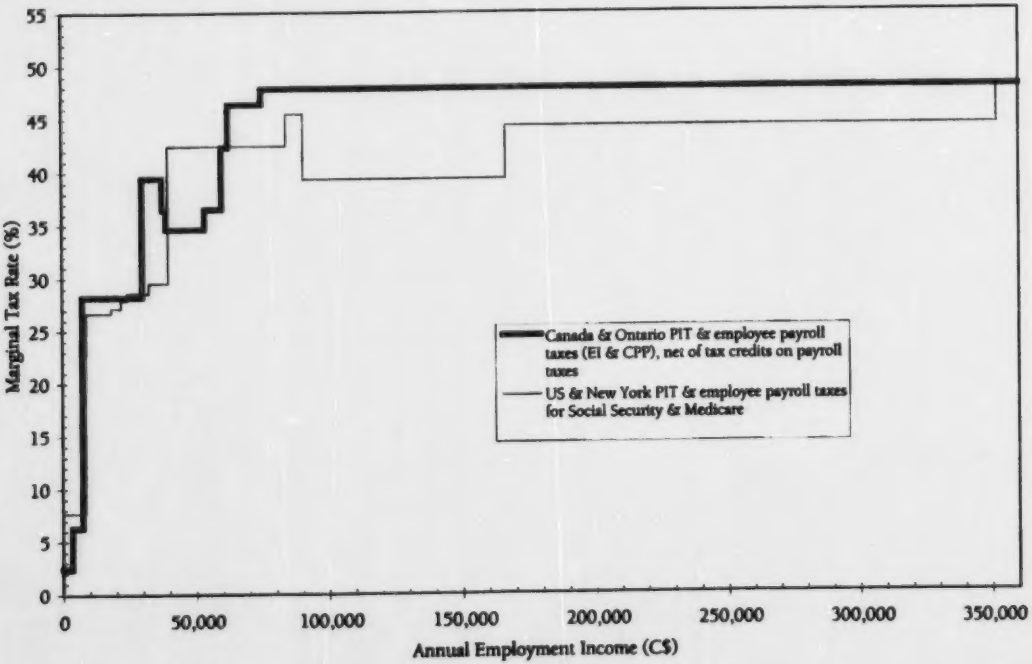


Figure 2
Total MTRs (income tax & payroll tax) in Ontario and New York, 2000, one-earner married couple with no children, all employment income

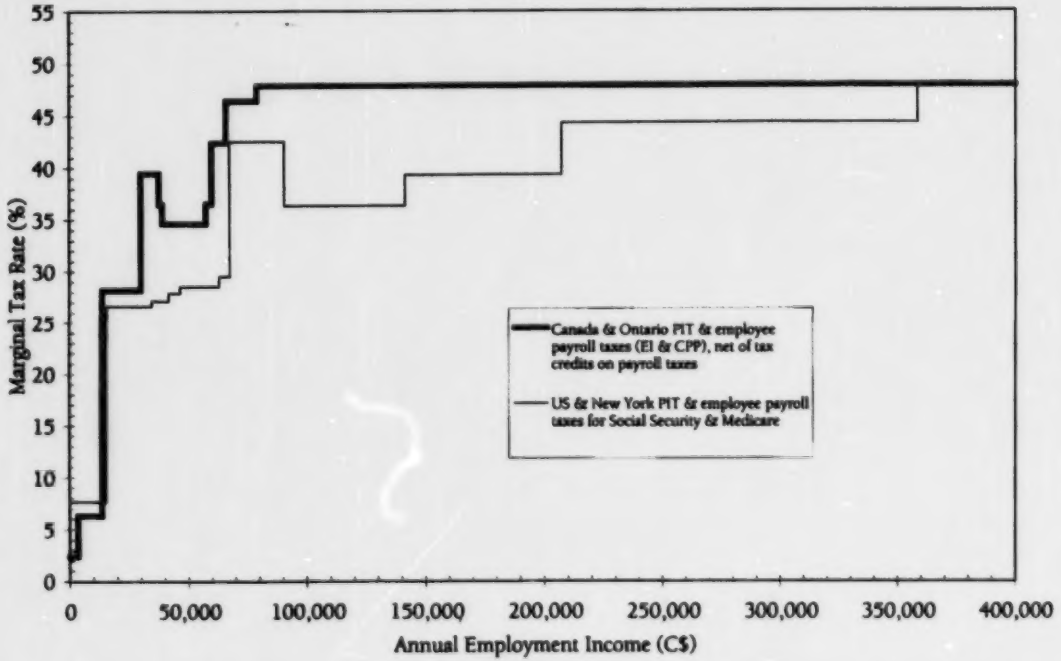
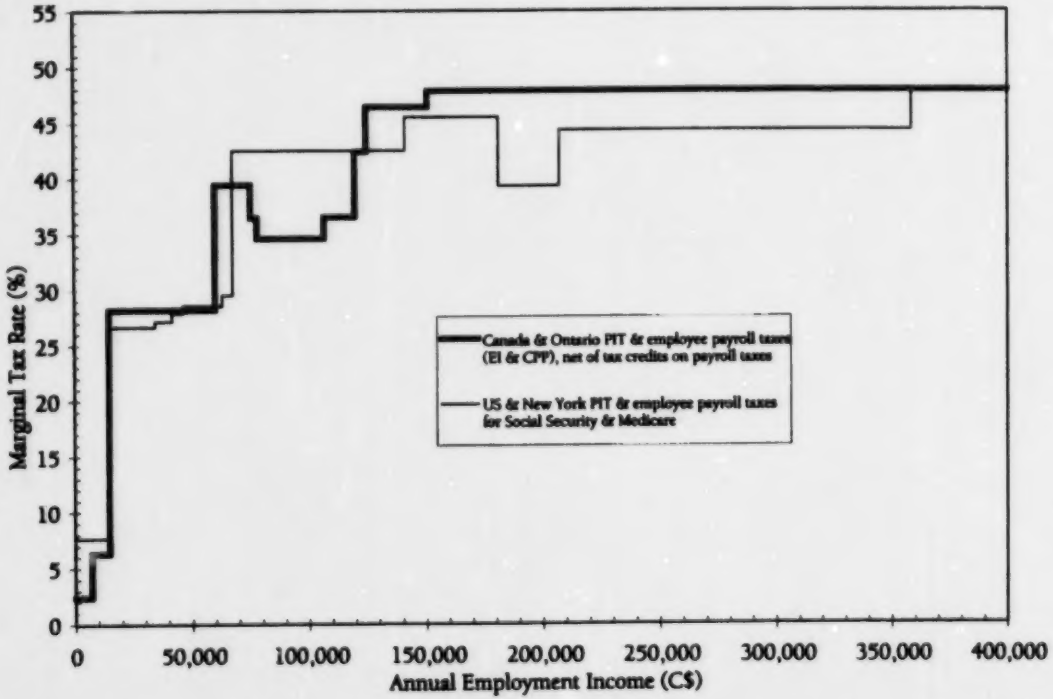


Figure 3
Total MTRs (income tax & payroll tax) in Ontario and New York, 2000, two-earner married couple with no children, all employment income



Summary on Canada/US comparison

Findings about comparative Canadian and US personal income taxes can be summarized as follows:

- Canada relies on the personal income tax in its overall revenue mix no more than the US, but both countries are considerably more reliant on income taxes than are other major economies.
- With its higher overall tax levels, Canadian income taxes are about 20 percent higher relative to GDP than are US income taxes; hence, matching US income tax burdens would require an overall cut of about one-sixth in Canadian income taxes.
- Federal taxable thresholds in Canada are generally below those for comparable household types in the US — although this is more an issue of social policy than tax competitiveness.
- Top federal MTRs are much lower in Canada than in the US for labour income, interest, dividends, and short-term capital gains, and just slightly higher for long-term capital gains.
- Income taxes of the Canadian provinces are much heavier than the counterpart US state taxes; including federal taxes and comparable state/provincial taxes, top MTRs in Canada are quite competitive with those in the US for labour incomes and interest, much lower in Canada for dividends and short-term capital gains, and somewhat higher for long-term capital gains.
- Top MTRs arise at lower income levels in Canada than in the US, but the difference is reduced when considering that two-earner couples file two separate returns in Canada.
- Total federal plus provincial/state MTRs including payroll taxes are significantly higher in Canada than in the US for single earners at upper-middle incomes (above the low $60,000s) and for one-earner couples at almost all incomes.
- For two-earner couples with equally split earnings, total MTRs are competitive up to $60,000 and are actually lower in Canada for incomes to $120,000, based on comparisons of a median-taxed state (New York) with a moderate-taxed province (Ontario).

If Canada wished to compete with the US on personal income taxes — for reasons that should be clearly articulated — there are thus four basic areas that would require change: (1) The income thresholds at which the middle and top brackets apply for federal tax need to be substantially increased, particularly for

the top bracket. (2) The tax rates applied in the federal income tax do not present problems, especially after the surtax is fully removed and the middle-bracket rate is reduced further. However, the surtax rates applied to high incomes in some provinces, such as British Columbia and Ontario, could be moderated or removed if they wish to be more competitive with no-tax and low-income-tax US states. Saskatchewan will be following this path, and others may follow. (3) The effective tax rates on long-term capital gains could be reduced further by trimming the inclusion rate to half. (4) While Canada would be well advised not to follow the US with many tax deductions and exclusions,[26] the American tax provisions for retirement savings (including both the levels and forms of tax-recognized savings) warrant scrutiny. These issues are pursued in later sections of the study.

Progressivity of Flat and Dual Taxes

Equity or fairness has two key dimensions for tax policy — vertical equity and horizontal equity. Vertical equity is a measure of how the overall tax burden is spread across income classes, or how steeply tax burdens rise with income levels. Horizontal equity is a measure of whether individuals or households with the same level of income or "ability to pay" are taxed equally. The flat and dual tax plans raise fundamental questions of both vertical and horizontal equity. This section examines the vertical equity aspects of each approach, while horizontal equity will be discussed in the next section, which examines tax treatment of the family. We begin by assessing tax progressivity under the flat tax and then examine the extent to which applying the dual tax rather than a flat tax would moderate the distributional outcomes.

Vertical equity is commonly identified with "progressivity," which means how quickly the tax burden rises with the income of the taxpaying unit. A tax is said to be progressive if taxes rise proportionally faster than income; that is, the average tax rate (ATR) or tax as a percentage of income rises with income. A tax is regressive if taxes rise proportionally slower than income, which is measured by an ATR that declines with higher incomes. And a tax is proportional if the tax is a constant percentage of income across income levels, indicated by a constant ATR. The ATR pattern of a tax is most relevant for vertical equity, whereas the level and pattern of MTRs are most relevant for the incentive and efficiency effects of the tax. Almost all major types of taxes except for personal and corporate income taxes are regressive in practice. Hence, if one desires some progressivity in the overall tax system or at least to mute the regressive effects of other

taxes, the personal tax rates must be structured to provide adequate progressivity. At issue is not only whether the personal tax is progressive, but exactly how progressive it is.

The flat tax plan and progressivity

Proponents of the Alliance flat tax maintain that their plan would be progressive even though it offers only a single tax rate above its expanded exemption levels. This approach departs from the typical personal tax rate schedule that consists of a series of successively higher MTRs as income increases. A flat tax does achieve somewhat progressive average tax rates through its basic exemption for taxfilers. This exemption relieves from tax a fixed amount of income, so that the flat or constant MTR on incomes above that threshold strikes a larger proportion of total income as income rises. Hence, the flat tax does produce a pattern of rising average tax rates as incomes rise, which satisfies the most common definition of a progressive tax. This point is made clearly in numerical examples offered by the Alliance in promoting their tax plan. Nevertheless, this type of tax rate structure offers much less scope for rate progressivity than a "progressive" tax rate schedule — one that applies a sequence of increasing MTRs for incomes at higher levels. In fact, the flat rate structure has average tax rates that rise quickly with income but level off as it approaches the statutory single tax rate and do not rise much more even at very high incomes.

Table 6 illustrates the pattern of average tax rates (ATRs) for the flat tax plan and for the federal income tax in 2000; for now we ignore the bottom panel showing the dual tax. The examples used to examine progressivity in this section are based on a simplified case involving a single taxpayer with no dependants and disregarding any deductions or credits besides the basic credit allowed a taxfiler.[27] The proposed flat tax plan would leave in place all other existing tax deduction and credit provisions, although it would increase the dollar and percent ceilings for tax-deductible registered savings. The general comparative properties of the two kinds of tax structure would be little changed by taking more detailed realistic assumptions, although of course the exact numbers would differ. Under the flat tax plan, the ATR rises quickly with income and hits 15.3 percent at a taxable income of $100,000, not much below its maximum value of 17 percent. In fact, a person with $1 million of income faces an ATR that is just 1.5 percentage points more than one with $100,000. In contrast, the existing federal income tax retains substantial progressivity even at very high incomes, with the ATR rising by more than 6.0 percentage points between the $100,000 and $1 million income levels.

Figure 4 shows how the average tax rate quickly levels out at incomes above $100,000 with the flat tax [ATR(f)], in contrast to its continuing rise even

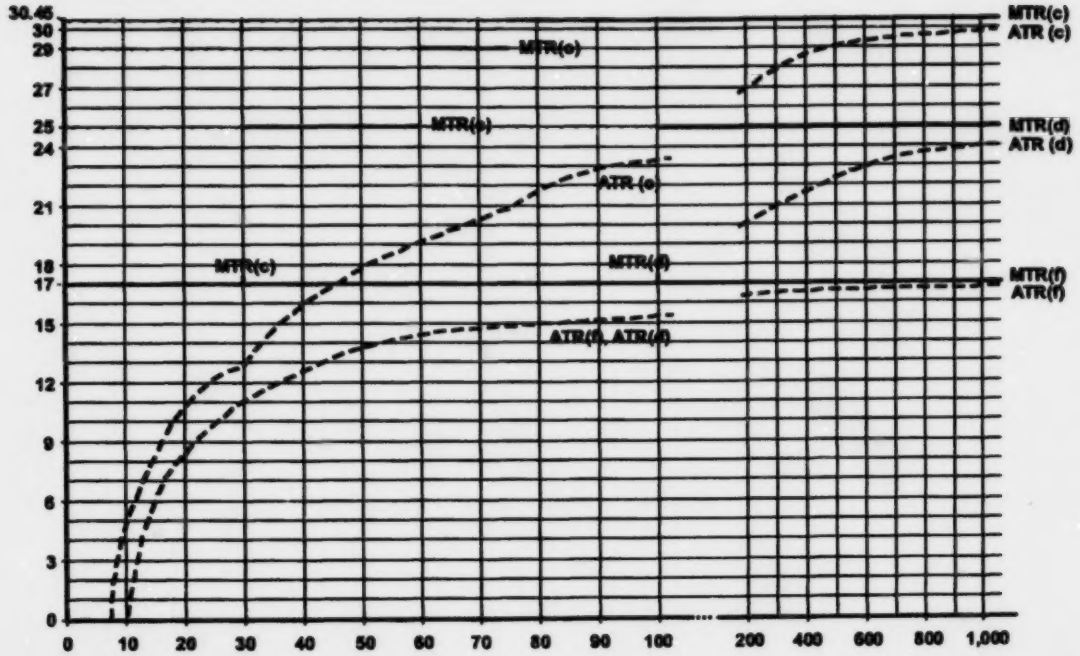
Table 6

Tax Savings of Flat and Dual Tax, Single Taxpayer in 2000[a]

Taxable Income ($)	Flat tax		Current federal tax		Cut in ATR	Tax savings			Percentage increase in net income[b]
	$	ATR (%)	$	ATR (%)	(% points)	$	% of tax	% of taxable income	
10,000	0	0.00	471	4.71	–4.71	471	100.00	4.7	5.1
15,000	850	5.67	1,321	8.80	–3.13	471	35.6	3.1	3.6
20,000	1,700	8.50	2,171	10.85	–2.35	471	21.7	2.4	2.8
30,000	3,400	11.33	3,871	12.90	–1.57	471	12.2	1.6	1.9
40,000	5,100	12.75	6,371	15.93	–3.18	1,271	19.9	3.2	4.2
50,000	6,800	13.60	8,871	17.74	–4.14	2,071	23.3	4.1	5.6
75,000	11,050	14.73	15,731	20.97	–6.24	4,681	29.8	6.2	9.1
100,000	15,300	15.30	23,344	23.34	–8.04	8,044	34.5	8.0	12.3
200,000	32,300	16.15	53,794	26.90	–10.75	21,494	40.0	10.7	17.9
400,000	66,300	16.58	114,694	28.67	–12.09	48,394	42.2	12.1	21.0
600,000	100,300	16.72	175,594	29.27	–12.55	75,294	42.9	12.5	22.1
800,000	134,300	16.79	236,494	29.56	–12.77	102,194	43.2	12.8	22.7
1,000,000	168,300	16.83	297,394	29.74	–12.91	129,094	43.4	12.9	23.0
	Dual Tax		*Current federal tax*						
200,000	40,300	20.15	53,794	26.90	–6.75	13,494	25.1	6.7	11.2
400,000	90,300	22.58	114,694	28.67	–6.09	24,394	21.3	6.1	10.6
600,000	140,300	23.38	175,594	29.27	–5.89	35,294	20.1	5.9	10.4
800,000	190,300	23.79	236,494	29.56	–5.77	46,194	19.5	5.8	10.3
1,000,000	240,300	24.03	297,394	29.74	–5.71	57,094	19.2	5.7	10.2

Notes: [a] Calculations assume only basic exemption, federal tax only (with 2000 values for middle bracket rate of 25 percent and surtax at five percent on basic federal tax above $15,500); ignores all other deductions and credits for employee payroll taxes, registered savings, etc.
[b] These figures are calculated relative to income net of federal income tax plus provincial tax, assuming that provincial tax equals 50 percent of the existing basic federal tax and that the provincial tax rates would be unaffected by the shift to a flat-rate federal tax.
Source: Author's calculations.

Figure 4
Average Tax Rates (ATRs) and Marginal Tax Rates (MTRs) for Current Tax, Alliance Flat Tax, and Dual Tax Plans, Single Individual, 2000



at higher incomes under the current federal income tax [ATR(c)]. The successively higher levels of marginal tax rates under the current tax [MTR(c)] act to continually pull up the ATRs at higher incomes. For the flat tax, the marginal tax rate [MTR(f)] is a uniform 17 percent across all income levels. For the current federal tax, MTR(c) is a series of segments: 17 percent up to $30,000; 25 percent from $30,000 to $60,000; 29 percent above $60,000; and an additional 1.45 percentage points for the surtax above $75,000. The gap between ATRs under the flat tax and the current system narrows for incomes as they rise up to $30,000 but widens continually and substantially for all higher incomes.

Material promoting the Alliance's flat tax stresses the progressive nature of the plan. One of its "Frequently Asked Questions" asks, "Isn't this [plan] regressive? Aren't you removing the progressive nature of the tax code?" The reply states, "No. A single rate tax system is truly progressive because it taxes incomes according to ability to pay while completely removing the genuinely poor among us from the tax rolls." It then proceeds to offer an example of a single parent with one child and a salary of $24,000, which obtains a $10,000 personal deduction plus a $10,000 spousal-equivalent deduction for the child as well as the $3,000 child deduction. Taxable income for that household would be $24,000 – $23,000 or $1,000, which would incur just $170 of federal income tax. It then notes that someone with $1 million of taxable income would pay $170,000 under the flat tax. It concludes, "The millionaire's income is 40 times that of the single parent but they pay 1,000 times more tax. That's progressive."

The difficulties with this notion of progressivity can be illustrated using Table 6 (albeit for a single taxpayer with no dependants). The table presents the tax savings that would result from shifting to the flat tax from the current tax for individuals with income ranging from $10,000 to $1 million.[28] At low incomes, below the $30,004 threshold for the current middle-rate bracket, the savings are a flat $471 regardless of income. This reflects the increased basic exemption under the flat tax ($10,000 – $7,231 = $2,769) multiplied by the existing bottom-bracket rate of 17 percent. The tax savings rise for those with higher incomes, as they benefit from the same $471 and also from the reduction in their tax rates to the single 17 percent rate on incomes above the $30,004. At middle incomes, the tax savings become fairly large, but at very high incomes they are truly massive. The tax savings are shown by income level as a percentage of original tax saved and as a percentage of taxable income. Both these measures give the appearance of a progressive pattern of rate cuts — tax savings that decline as a percentage with income — but only for the lowest incomes up to $30,000.[29] For higher incomes, taxes saved as a percentage of either taxes or of income rise steadily and sharply with income level. At $30,000, the tax savings are 12.2 per-

cent of tax and 1.6 percent of income, but at $100,000 these figures rise to 34.5 and 8.0 percent, respectively. The last column shows the percentage increase in disposable income (assuming a provincial tax at 50 percent of the basic federal tax) from the tax shift. This increase is 5.1 percent at $10,000, declines to 1.9 percent at $30,000, and then rises to 12.3 percent at $100,000 and 23.0 percent at $1 million. It is notable that the smallest proportionate rise in net income occurs at close to the median taxpayer income.

One can use the results in Table 6 to make comparisons similar to those made in the Alliance's information material. For example, comparing single persons at $40,000 and $1 million, the tax savings from the flat tax are over 100 times as large for the latter ($129,094 compared to $1,271) although the income is only 25 times as large. This presents a very different picture of the "progressivity" of the flat tax plan, one that reveals that this kind of approach tends to produce greater tax cuts for those at upper incomes relative to those at middle incomes. The Alliance's "Frequently Asked Questions" include the question, "Doesn't a single rate tax hurt the middle class?" with its reply, "No! A 17 percent single rate will provide significant tax relief to the middle class...Our plan dramatically reduces the tax burden for all taxpayers — including the middle class." However, retaining progressivity of MTRs above middle incomes would allow for considerably larger tax cuts for the middle class, with less of the total tax savings going to those at very high incomes. Another "FAQ" asks, "Don't the rich benefit the most under your plan?" The reply is, "We're not going to apologize for a plan that lowers taxes for all low, middle and upper income Canadians." While the statement is factually correct, it excludes alternative ways of dividing the pie that do not unduly favour upper-income Canadians.

One way to understand the distributional impact of the Alliance flat tax is to decompose the tax savings into its two principal components — the flattening of the tax schedule to a single rate and the large increase in the deductions for filers (and dependent spouse and children). Table 7 shows the results of this decomposition, again using the simplified example of the single taxpayer. The tax savings from the increased basic deduction are a uniform $471 across all income levels, even the highest.[30] At $10,000 of taxable income, this represents a 100 percent tax reduction, but this percentage declines steadily and sharply with higher incomes; at $100,000, it is just a 2.0 percent tax cut. Clearly, this component of the flat tax is most important in reducing taxes for individuals at very low incomes. In contrast, the tax savings from the flat tax rate are zero for incomes below the current $30,004 threshold for the middle-rate bracket, but they rise steadily and sharply with higher incomes. At $50,000, the savings are 18.0 percent of taxes; at $100,000, 32.4 percent of taxes; and at $1 million, 43.3 percent of taxes. The

Table 7
Tax Savings of Flat Tax from Higher Threshold and Flat Rate, Single Taxpayer in 2000[a]

Taxable Income $	Saving of flat tax from: Higher exemption $	Higher exemption % of tax[b]	Flat rate $	Flat rate % of tax[b]	Total savings $	% of total savings from flat rate
10,000	471	100.0	0	0.0	471	0.0
15,000	471	35.6	0	0.0	471	0.0
20,000	471	21.7	0	0.0	471	0.0
30,000	471	12.2	0	0.0	471	0.0
40,000	471	7.4	800	12.6	1,271	63.0
50,000	471	5.3	1,600	18.0	2,071	77.3
75,000	471	3.0	4,210	26.8	4,681	89.9
100,000	471	2.0	7,573	32.4	8,044	94.1
200,000	471	0.9	21,023	39.1	21,494	97.8
400,000	471	0.4	47,923	41.8	48,394	99.0
600,000	471	0.3	74,823	42.6	75,294	99.4
800,000	471	0.2	101,723	43.0	102,194	99.5
1,000,000	471	0.2	128,623	43.3	129,094	99.6

Notes:
[a] See note a to Table 6.
[b] Relative to current federal tax.

Source: Author's calculations.

amount of tax savings from the flat rates are much greater than the $471 at middle incomes and become massive at high incomes.

As shown in the last column of Table 7, most of the action from the flat tax plan for incomes around $40,000 comes from the flat rate and not the enlarged deductions. At $75,000 incomes, 89.9 percent of the total tax savings for a single person stems from the flat rate. The revenue costs reported by the Alliance for its original flat tax plan confirm that the flat tax rate is a larger part of the package than the increased deductions.[31] It puts the annual revenue costs (or tax savings) of the various components as follows: increase in the exemption for filers and spousal/equivalent status, $8.26 billion; introduction of a new $3,000 deduction for children under age 16, $2.37 billion; and cutting all higher tax rates to the flat 17 percent, $17.16 billion. The material also reports that the flat tax would remove 1.4 million low-income Canadians from the tax rolls.[32] This result, however, is the consequence solely of the increased exemptions, and it could be achieved without any change in the federal tax rate schedule if that were desired.

Table 8
Distribution of Individuals by Personal Income Tax Bracket (Federal), 1999

Federal basic marginal tax rate* (%)	Distribution of individuals (%)	
	All individuals	Taxpayers only
zero (no income)	23.9	—
zero (some income)	25.5	—
17	28.5	56.3
26	17.9	35.4
29	4.2	8.3
All	100.0	100.0

*Excludes the effects of surtax rates and clawback rates.

Source: Adapted from Alan Macnaughton, Thomas Matthews, and Jeffrey Pittman, "'Stealth Tax Rates': Effective Versus Statutory Personal Marginal Tax Rates," *Canadian Tax Journal*, Vol. 46, no.5 (1998), pp. 1029-66, Table 3.

A look at the distribution of taxfilers across the three existing federal tax brackets reveals how the benefits of a single tax rate would be disbursed. Table 8 shows this distribution for all individuals, including non-taxable persons and those claimed on others' tax returns. Nearly half of all individuals (49 percent)

face a zero MTR on any incremental income; only four percent fall into the top bracket. Restricting the count to those who face a positive MTR, as reported in the table's last column, also shows that taxpayers are concentrated in the lowest tax bracket. More than half (56 percent) of all persons facing a positive federal tax rate are in the bottom bracket of 17 percent. Since the flat tax would reduce all federal MTRs to 17 percent, this group of more than half of all taxpayers (and nearly 78 percent of all individuals) would gain nothing from the reduction in tax rates to a single rate. The middle tax bracket constitutes just over one-third (35 percent) of all individuals subject to federal tax; they will get a modest break from cutting the rate to 17 percent. The largest cut in tax rates from the flattening of rates will go to those now in the top bracket, who represent just eight percent or about one out of 12 taxpayers.

The impact of the flat tax plan on various income groups can be examined with the aid of Tables 9 and 10, which show estimates for individuals and family units, respectively. For now we ignore the columns with figures for the dual tax.[33] The results presented here do not take into account the Alliance proposals to raise the contribution limits for registered savings plans and to cut the tax inclusion rate for capital gains. As will be explained later, the higher contribution limits would be of principal benefit only for persons with earnings above $75,000 per year, so that the distributional results would only be exacerbated by including this provision. The reduced tax inclusion rate for capital gains would be of disproportional benefit to persons and households at the highest incomes, where this source of income is highly concentrated. But based on evidence from other countries, the lower tax rate would increase the rate at which capital gains were realized, which would have an offsetting impact on the share of taxes paid.[34]

If the main features of the flat tax plan were fully implemented in 2000, average individual (or family) federal income taxes payable would fall by 32.2 percent. However, as shown in the next-to-last columns of Tables 9 and 10, these percentage tax savings vary by income level with an overall U-shaped pattern. The percentage cuts are greater than average only for individuals with incomes below $20,000 and above $75,000 and for families with total family incomes below $25,000 and above $140,000. As a result, the *relative shares* of the total income tax burden are increased under the flat tax for those with moderate to upper-middle incomes — namely, for individuals with incomes between $20,000 and $75,000 and for families with total family incomes between $25,000 and $140,000.[35] While the very lowest income groups enjoy the largest percentage cuts in their federal taxes, the percentage cut in the share of total tax revenues is much larger for the much smaller group of very high-income taxpayers. Individuals with incomes below $20,000 (23.5 percent of taxable filers) have

their total share of federal tax cut by 0.94 percentage points, but individuals with incomes above $75,000 (just 7.1 percent of taxable filers) have their share cut by 3.14 percentage points. Although the tabulated shifts in tax shares may appear to be small, they are quite significant in relative terms. For example, the 1.46 percentage cut in the tax share of individuals with incomes over $250,000 is 13 percent of its existing 11.15 percent share.

Moreover, these figures mask the massive amount of tax savings from the flat tax that would be provided to the small numbers at higher incomes. For families with incomes above $225,000, which is just 0.9 percent of all families, the aggregate tax savings would be $4.7 billion per year — nearly six percent of the $79 billion in total federal income taxes or 19 percent of the $25 billion in tax cuts under the flat tax plan. At incomes above $1 million, our estimated total tax savings would be in the order of $1 billion per year. Given that there are only about 4,600 individuals or 5,600 families in this income range, the average annual saving per unit would be about $200,000. The tables also indicate why the adoption of a flat tax would entail so much revenue loss even though there are relatively few people at higher incomes. For example, one finds there are just over 9 percent of all families with incomes above $100,000. Yet they receive in aggregate 31 percent of all income assessed under the tax and they pay over 44 percent of all federal income taxes under the current progressive rate structure. And for individuals at very low incomes the aggregate dollar savings are very small despite their large percentage cut in taxes, because they pay little tax at present. For individuals with incomes below $10,000, who pay just $68 million under the current income tax, the 85.7 percent tax savings from the flat tax amounts to only $58 million.

The dual tax plan and progressivity

The Alliance's transitional shift in policy from a flat tax to a dual tax was presented as driven by cost considerations and increased priorities given to federal spending and debt reduction. Most political observers believe that the shift was dictated instead by concern about the political vulnerability of a proposal with tax cuts so heavily weighted to very high income groups.[36] Thus a key question is the extent to which the shift to a dual tax would moderate the distributional effects that have been shown for the flat tax. The only significant difference between the flat and dual tax plans is that a second, higher MTR of 25 percent would apply to individual taxable incomes above $100,000. Therefore, for couples with equally divided incomes, the higher tax rate would not bite until family incomes reached $200,000. Based on our simulations, it is estimated that the shift from a flat tax to a dual tax would, if each were applied in 2000, raise net

federal tax revenues by just about $2.4 billion, or only three percent of current total federal income taxes.

The bottom panel of Table 6 repeats for the dual tax the earlier analysis of impacts on average tax rates by income. All the results for the dual tax are the same for incomes up to $100,000, so that the upper panel still applies in that range. It can be seen that the dual rate does substantially mute the cuts in ATRs at very high incomes relative to the flat tax. Instead of cuts to ATRs exceeding 12 percentage points for incomes of $400,000 to $1 million, these are reduced by more than half to cuts of 6 percentage points or less. Nevertheless, these cuts are still larger than those for any of the income levels below $75,000. Figure 4 shows the pattern of ATRs for a dual tax [ATR(d)] alongside those for the flat tax and the current federal tax. In dollar terms per individual, the dual tax also cuts the savings, relative to the flat tax, by more than one-third at the $200,000 income level and by well over half at the highest income levels shown. Tax savings under the dual tax as a percent of tax paid under the current federal tax show a declining pattern at the higher incomes, instead of their ever-increasing pattern with the flat tax. Still, these figures at the highest incomes exceed those for individuals with incomes of just $30,000. Tax savings for high earners both as a percentage of their income and the implied percentage increase in their disposable income are dampened by about half when using a dual rate rather than a flat tax. But both of these types of measures still show much larger percentage gains for those at very high incomes than for individuals with incomes of $50,000 or lower — quite apart from the vastly larger dollar savings.

Table 9 shows the same kinds of figures for distribution of the tax burden for the dual tax as were previously examined for the flat tax for individuals. The dual tax offers a total tax reduction of 29.2 percent. Since the flat tax reduced the net federal income tax revenues by 32.2 percent, this is about a one-tenth smaller total tax cut overall. All of this curtailed tax reduction is at the expense of individuals with incomes above $100,000 and families containing any such individuals. The share of net federal tax for income groups up to $150,000 is slightly smaller under the dual tax than under the flat tax. This situation reverses for higher incomes, with the tax share larger under the dual tax than under the flat tax. For individual filers, the tax share for incomes in the $150,000–250,000 range is almost the same under the dual tax as the current tax. For individuals with incomes above $250,000, the tax share is more than a full percentage point higher (12.30 versus 11.15 percent) under the dual tax vis-à-vis the current tax. Hence, the dual tax does succeed at the top incomes in preventing an adverse shift in the total tax burden. Nevertheless, in the middle-income range where there are far more taxpayers than at the top, the dual

Table 9
Distribution of Federal Personal Income Taxes, Current vs. Flat Tax and Dual Tax, by Individual Income Class, 2000[a]

Individual Income class ($)	% of all filers	% of taxable filers	% of total income assessed	% of net federal tax under:			Change in % share of net federal tax		% change in tax burden with	
				current tax	flat tax	dual tax	flat tax	dual tax	flat tax	dual tax
Less than 10,000	17.67	2.27	1.92	0.09	0.02	0.02	–0.07	–0.07	–85.7	–85.7
10,000-20,000	25.58	21.19	10.15	3.14	2.27	2.18	–0.87	–0.96	–51.0	–51.0
20,000-25,000	9.02	11.11	6.06	3.45	3.56	3.41	0.11	–0.04	–30.2	–30.2
25,000-30,000	8.22	10.75	7.05	4.75	5.33	5.11	0.58	0.36	–23.9	–23.9
30,000-40,000	13.28	18.16	15.01	12.08	13.63	13.06	1.55	0.98	–23.5	–23.5
40,000-55,000	12.74	17.66	19.76	19.94	21.26	20.36	1.32	0.42	–27.7	–27.7
55,000-75,000	8.45	11.81	17.87	21.37	21.89	20.97	0.52	–0.40	–30.6	–30.6
75,000-100,000	2.81	3.94	7.94	10.64	10.30	9.88	–0.34	–0.76	–34.3	–34.3
100,000-150,000	1.38	1.91	5.35	8.08	7.39	7.38	–0.69	–0.70	–38.0	–35.3
150,000-250,000	0.51	0.72	3.23	5.31	4.66	5.35	–0.65	0.04	–40.5	–28.8
250,000 and over	0.35	0.49	5.66	11.15	9.69	12.30	–1.46	1.15	–41.1	–21.9
Total or average	100.00	100.00	100.00	100.00	100.00	100.00	0.00	0.00	–32.2	–29.2

Notes:
[a] Calculations for the flat tax include proposed changes to exemptions, new child deduction, and tax rates; proposed changes to contribution limits for registered savings and tax inclusion rate for capital gains are not considered here. Calculations for the existing tax include the provisions of the 2000 budget for the 2000 tax year and the two-thirds tax inclusion rate for capital gains. Note that the proposed child deduction is assumed to be claimed by the higher-income parent (this was not specified in the flat tax program details), but this should not have a significant impact on the distributional results.

Source: Tabulations by the author based on simulations by IRPP using the SPSD/M.

tax still creates an adverse shift in shares of the tax burden for individuals. Those with incomes between $25,000 and $55,000 bear a larger share of the total taxes with the dual tax than with the current tax. The dual tax creates a peculiar shift in tax shares: very low-income groups gain (with smaller shares), middle-income groups lose, upper-middle-income groups gain (by more than those at very low incomes), and very high-income groups lose. This result is unlike the previous finding for the flat tax, where all the "share losers" were found in the moderate- to middle-income group.

The distributional effects of the dual tax differ significantly when viewed on the basis of family incomes. This arises in part because many upper-middle family incomes stem from the earnings contributions from two (or more) members, each of whom is taxed at the 17 percent rate on earnings below $100,000, even if total family income exceeds this figure. As seen in Table 10, virtually all family income classes below $225,000 gain in the sense that their share of the total tax burden declines with a dual tax. The only exception is the range of family incomes from $70,000 to $100,000, where there is no change, although there are some small gains and losses for income groups more finely divided within this range.[17] For families, all of the reduced share in total federal tax revenues that results from the dual tax is enjoyed at the expense of the highest income group — those above $225,000 — who bear an additional 1.76 percentage point share of the total tax burden. Note that these estimates do not include the impact of two other important features of the Alliance plan for personal taxes — the increased contribution limits for registered savings and the reduced capital gains tax rate. It is improbable that taking the former factor into consideration would reverse our findings. The proposed increase in allowable contributions to $16,500 would benefit only individuals whose annual earnings exceed $75,000 but would be of proportionally little benefit for families above $225,000. The capital gains tax cut is potentially of much larger benefit to very high income groups, but it is unknown the extent to which they would realize more taxable gains and thereby pay offsetting amounts of taxes.

These findings indicate that the dual tax would reduce, but not fully eliminate, the negative effect of a flat tax for moderate- and middle-income individuals in terms of their tax shares relative to the current federal tax. It would also substantially increase the tax share of very high-income (above $250,000) individuals. Of course, all individuals would have their taxes cut under the scheme, and it is simply a matter of which groups would have their taxes cut proportionately more. More striking is our finding that the dual tax would almost completely eliminate the adverse shift in tax shares relative to the flat tax when viewing taxpayers on a family income basis. Almost all income

Table 10
Distribution of Federal Personal Income Taxes, Current vs. Flat Tax and Dual Tax, by Family Income Class, 2000[a]

Family[b] Income class ($)	% of families	% of total income assessed	Current net taxes (million $)	% of net federal tax under:			Change in % share of net federal tax		% change in tax burden with	
				current tax	flat tax	dual tax	flat tax	dual tax	flat tax	dual tax
Less than 15,000	17.22	2.16	158	0.20	0.09	0.09	–0.11	–0.11	–69.5	–69.5
15,000-25,000	16.58	5.22	1,400	1.76	1.60	1.53	–0.16	–0.23	–38.6	–38.6
25,000-35,000	13.37	7.38	3,152	3.97	4.04	3.87	0.07	–0.10	–31.0	–31.0
35,000-50,000	15.44	13.06	7,693	9.69	10.00	9.58	0.31	–0.11	–30.1	–30.1
50,000-70,000	15.27	18.73	13,662	17.22	17.89	17.13	0.67	–0.09	–29.6	–29.6
70,000-100,000	12.81	22.33	18,521	23.34	24.37	23.34	1.03	0.00	–29.2	–29.2
100,000-140,000	6.06	14.77	14,025	17.67	18.04	17.38	0.37	–0.29	–30.8	–30.4
140,000-225,000	2.36	8.38	9,098	11.46	11.05	11.19	–0.41	–0.27	–34.6	–30.9
225,000 and over	0.89	7.97	11,647	14.68	12.92	15.88	–1.76	1.20	–40.3	–23.4
Total or average	100.00	100.00	79,355	100.00	100.00	100.00	0.00	0.00	–32.2	–29.2

Notes:
[a] See note a to Table 9.
[b] Census definition of the family, which includes unattached individuals.

Source: Tabulations by the author based on simulations by IRPP using the SPSD/M.

groups below $225,000 would have smaller tax shares than exist under the current federal tax, and the increased share would be borne almost solely by families above $225,000 (possibly offset by the capital gains tax cuts). Yet it is critical to understand that even this kind of tax policy change would reduce the progressivity of the overall tax system. The personal tax is the largest and almost only progressive component of the total tax system. A large cut to personal taxes, even if the cuts were completely proportional and thereby left the relative tax shares of all income groups unchanged, would by its nature reduce overall tax progressivity. This is because it would reduce the relative weight of the revenue source that is progressive.

Overall progressivity and tax jurisdiction

Substantial progressivity of personal income taxes is required if society wishes to have an overall tax system that is even mildly progressive. Most of the other major types of taxes in Canada have been assessed as regressive, with the exception of the corporate income tax.[38] Large revenue generators such as general sales taxes (provincial retail sales taxes and federal GST), excise taxes on alcohol, tobacco, and gasoline, municipal property taxes, and federal payroll taxes are all significantly regressive. Because of saving and spending patterns, sales-type and property taxes take a larger portion of lower than of higher incomes. The taxable ceilings for most payroll taxes also make them relatively more burdensome for lower than higher earners. Even with alternative assumptions about who bears the tax or taking a lifetime perspective on burdens, these taxes are at best somewhat regressive.[39] Hence, any proposal to sharply reduce the progressivity of personal income taxes, such as a flat tax plan or even the proposed dual tax, risks the creation of an overall tax system that is regressive. If one desires a progressive tax system — and this is a value judgment that one need not accept — then retaining significant progressivity in personal taxes is essential.

A final issue concerning tax progressivity is the proper level of government for applying redistributive taxes. A US empirical study finds that attempts to redistribute through state-level taxes do not succeed.[40] States with more progressive tax systems lose higher-skilled workers until their gross salaries rise to offset their higher taxes. In effect, the employers bear the impact of more progressive taxes, and the result is the loss of more skilled and highly paid jobs to other states offering less progressive taxes.[41] One might expect similar economic effects to arise in Canada via inter-provincial mobility of labour, although residents of some regions may tolerate higher tax burdens without migrating for reasons of language or culture. Otherwise, the

provinces will be thwarted in their attempts to redistribute via progressive taxes. Those provinces that apply more progressive taxes may only be harming their high-tech and growth sectors.[42] Yet if the provinces are constrained in this way, this leaves the federal government as the sole jurisdiction that can effectively apply a substantially progressive income tax. Thus, a flat rate tax might be an acceptable prescription for provincial policy (and Alberta will go this route in 2001), but it is inappropriate policy for the federal government if vertical equity is a concern.

Equitable Family Taxation

In the analysis underlying the Alliance's original flat tax plan, the primary justification for adopting a single tax rate was horizontal equity between one-earner and two-earner couples.[43] Simplicity and efficiency were cited as secondary considerations. The arguments ran as follows:

> *Simply, the principle of horizontal equity asserts that two individuals earning the same amount should pay the same amount of tax. Similarly, two families earning the same amount should pay the same amount of tax...[A] fundamental breach of horizontal equity in the Canadian personal income tax system...[arises from] the choice of the individual as the unit of taxation and the use of one rate structure with multiple marginal rates. The result is that two families with identical total family incomes will have significantly different tax liabilities if one family has a single-income earner and the other two income earners...*[44]

This section assesses the implicit assumption that equal incomes are equivalent to equal ability to pay taxes when comparing one- and two-earner couples. The ways that the flat tax and dual tax plans address this issue are investigated. We then examine whether there are other solutions to this problem — if it is indeed a problem — that do not fully abandon marginal tax rate progressivity. The horizontal equity issue relating to dependent children in the tax system, and the Alliance approach to this issue, are then assessed.

One-earner vs. two-earner families

The analysis outlined by the Alliance assumes that the ability to pay taxes should be judged across taxpaying units based on their incomes.[45] This assumption might be valid when comparing taxpaying units of the same size

and composition. However, when comparing one-earner couples with two-earner couples, market incomes neglect a major difference — the additional time that a non-employed spouse has available for producing services in the home. These services include cooking, laundry, housecleaning, shopping and other errands, home and auto repairs, and child-minding; all these services are costly to purchase in the market. The two-earner couple needs to purchase much more of these services to be on a par with the one-earner couple. Rational couples will choose to have one partner stay at home to provide these services only when their monetary and psychic value exceeds the net income that could be earned by working in the market.[46] Hence, market incomes do not offer a reliable measure of the relative abilities to pay tax, or the relative well-being, of one- and two-earner couples. A one-earner couple with $60,000 of earnings per year is not equivalent to a two-earner couple with individual earnings of $20,000 and $40,000 that total the same $60,000. The latter couple has less time to be productive in the home, greater household expenses, and a lesser ability to pay taxes, and hence should bear a lower total tax burden. And the former couple could have an income above $60,000 if the second spouse took paid work.

The preceding line of analysis has been used in several recent Canadian studies to support the continued taxation of families based on individual incomes.[47] Nevertheless, some countries allow various forms of income splitting or joint family taxation; the US and France are examples. One might justify that approach by considering factors beyond those in the cited analysis. First, one-earner couples will in some cases be the result, not of a rational choice to have one partner stay out of the labour market, but of an inability to find a paying job; then much of the home time will be enforced leisure rather than productive time. Second, when one partner is highly paid in a job that is very demanding, it may be rational for the other partner to serve in a supporting role by bearing all of the home and child responsibilities. In effect, the two partners are working jointly for one demanding paid job and one demanding unpaid home job. Some years ago, in terms that today might be regarded as sexist, John Kenneth Galbraith described this as the need for a "wife" for "consumption administration."[48] Yet another factor might be a societal value of having at least one parent at home to help raise and nurture pre-school children.[49] In the end, it is a matter of personal values whether these cases support a preference for joint taxation over individual taxation.

If one accepts the validity of these arguments for assessing ability to pay based on the joint incomes of married couples, then horizontal equity requires changes to the current tax system. The Alliance analysis identifies two distinct

remedies to restore equity and opts for the single tax rate solution.[50] First, couples could be allowed to file joint returns with modified tax schedules to allow income splitting; one form of this would provide joint married tax brackets twice as wide as the brackets allowed for single filers. This method would retain progressivity of MTRs and continue to serve vertical equity. Alternatively, a single tax rate combined with equal and transferable exemptions for both spouses could be another way to achieve this view of horizontal equity. The latter is the Alliance's preferred solution to the issue of one-earner couples and, unlike the other approach, would fully eliminate MTR progressivity.

Joint filing and horizontal equity

The essential choice is between some form of joint filing with modified but still progressive rate schedules and retaining individual filing but adopting a single tax rate. The Alliance analysis rejects the joint filing method for three reasons. First, it asserts that joint filing would compromise privacy: "spouses may prefer some economic autonomy and keep their financial matters private."[51] Yet, their plan would also require the exchange of information within the couple in that transferring the lower-income spouse's unused exemption reveals their income. Moreover, the tax package keeps the existing Child Tax Benefit, which requires that the incomes of both partners be disclosed.[52] Second, it argues that joint filing would require solving a technical problem called "adult equivalents," which is the question of how much income splitting to allow. Two adults living together can achieve scale economies — savings from shared costs of housing, furnishings, car and appliances, phone and utilities, and from volume purchases of food and household supplies. If horizontal equity is based on well-being or ability to pay, rather than a simple income measure, then less than full income splitting is appropriate.[53] Studies by Statistics Canada offer answers to the issue of adult equivalents, but the Alliance solution assumes that there are no scale economies. Third, the Alliance analysis states that joint filing "would lead to greater complexity, making administration and compliance more difficult." This point is assessed below and is found to have little substance.

Several other arguments can be cited for adopting joint taxation with at least partial income splitting for married couples in Canada. First, joint filing substantially reduces the complexity of financial planning and accounts for married couples, and it also reduces the complexity of their tax planning and filing. Under the current system, married partners must do complex calculations for many decisions to determine their jointly optimal investment strategies. Second, joint filing would restore a different aspect of horizontal equity — between married couples with only labour earnings and those with significant amounts of

self-employment or capital incomes and savings. The latter are already able to pursue many legal strategies to achieve income splitting: (1) deposits to spousal RRSPs; (2) the lower-earning spouse doing all of the couple's savings with the higher-earning spouse doing all their spending; (3) interspousal loans, which can escape the attribution rules with respect to capital gains; and (4) the self-employed and those with incorporated businesses shifting income to their spouse via paid positions and dividends. Joint filing would extend similar benefits of income splitting to those with only employment earnings. Introducing joint filing in Canada would also make the tax burdens for highly paid workers with either an at-home or lower-earning spouse more competitive with the counterpart US tax burdens.[54] The bottom line is that joint filing could achieve the same horizontal equity as the flat tax while retaining progressivity.

The flat tax plan and horizontal equity

The flat tax plan would raise the basic taxfiler exemption from the current $7,231 to $10,000 and the spousal/equivalent-to-spousal exemption from its current $6,140 to $10,000.[55] Equalizing these two figures is necessary to achieve the plan's asserted horizontal equity between single- and dual-earner couples while using individual tax filing. As with the present tax system, a spouse with income below the taxable threshold could transfer the unused part of the exemption to their spouse, which is a limited form of joint filing. While this approach achieves horizontal equity based on a simple income notion, it does not achieve equity based on ability to pay. As explained previously, two persons living together can live more cheaply than two persons living alone at the same real living standard. The Alliance plan ignores this dimension and creates horizontal inequities between married couples (whether one- or two-earner) and single adults. The couples are taxed relatively lightly, the singles comparatively heavily. In the US system of joint filing, these scale economies are recognized by the use of a standard deduction for married couples that is less than double that for singles (US$7,350 versus US$4,400)[56] and tax brackets for joint filers that are less than double those for single filers (see Table 2).

It should be noted that the transitional shift of policy from a flat rate to a dual rate scheme would compromise its ability to achieve the asserted form of horizontal equity for couples. Namely, for those couples with at least one partner earning above the proposed $100,000 threshold for the higher tax rate, one- and two-earner couples with the same total incomes would still bear different total tax burdens. Even though such one-earner couples could transfer the full enlarged spousal credit to the earning spouse, this would not achieve the same result as income splitting. The dual tax could claim that the problem would then

be restricted to the very small proportion of all taxpayers where one partner of a couple has earnings above $100,000. And the dual tax plan's diminished spread between the unchanged bottom rate of 17 percent and the reduced top MTR of 25 percent would also reduce the degree of horizontal inequity. As with any tax structure that is progressive in MTRs, the dual tax would need some form of joint filing or other income splitting to fully achieve the asserted goal.

Dependent children and horizontal equity

The flat tax plan would introduce a $3,000 deduction per dependent child.[57] This would restore some degree of horizontal equity between taxpaying households with and without children at upper-income levels. With the tax changes that accompanied the Child Tax Benefit scheme in 1993, taxpayers with children and high incomes face the same tax burdens as other taxpayers with the same incomes but no children.[58] This situation ignores the fact that families with the same incomes but more dependants have a lower ability to pay taxes, as they have less discretionary income. We next examine whether this plan offers the best remedy for this situation, but first an anomaly of the Alliance proposal is noted. The plan would allow a single parent to claim both this child deduction of $3,000 *and* the equivalent-to-spouse exemption of $10,000 on behalf of the same child; hence the single parent's total deductions including the filer amount would be $23,000. In contrast, when the federal tax system allowed non-refundable tax credits for children before 1993 and exemptions for children before 1988, a sole parent could claim the equivalent-to-spouse amount only in lieu of the child amount. By allowing sole parents to claim both, the Alliance scheme would create a tax inequity vis-à-vis two-adult households with no children. The latter would be able to claim deductions of only $20,000, even though their essential spending needs are likely comparable to those of the one-adult, one-child household.

One feature of the proposed new child deduction is noteworthy. The plan proposes to disallow the first $3,000 of expenses that can be claimed as child care expense deductions, while leaving the upper limits unchanged ($7,000 annually per child under age 7 and $4,000 for ages 7 through 16). The goal here was to "universalize" the tax recognition of the costs of child care, including care provided by at-home parents for their own children. The $3,000 deduction would be allowed for all parents regardless of whether they incurred cash expenses for child care. This provision would raise the relative cost for parents (typically mothers) working in the paid labour force versus staying home to care for their children, as they would no longer get an extra tax deduction by incurring the first $3,000 of child care costs. For those who wish to encourage more parental care of children at home, this is a desirable effect; those who prefer to

promote the labour force skills and financial independence of women might deem this an undesirable effect.[59]

Several studies have examined the tax treatment of dependent children, as well as structural problems with the Child Tax Benefit (CTB). They warrant comparison with the solution put forward by the Alliance tax plan, which has a $3,000 per child deduction along with the existing unreformed CTB system. The alternatives proposed by others include various combinations of: (1) instituting a child exemption within the income tax;[60] (2) instituting a non-refundable child tax credit;[61] (3) instituting a universal child benefit (or a refundable child tax credit without any income test);[62] (4) moderating the rates of benefit phase-outs in the existing CTB;[63] and (5) combining the last two elements by reducing and stopping the CTB phase-out at a median income level, so that a partial child benefit remains for higher-income families.[64] These schemes have sought to remedy the tax recognition of children at all incomes for horizontal equity and reduction of the high effective MTRs that arise with the CTB and some related provincial schemes. Combined with the MTR of the tax system, these total MTRs rise into the 60 percent range for incomes of $20,000 to $30,000, and for certain incomes rise as high as 70 percent in British Columbia and 91 percent in Saskatchewan.[65]

Normally, an exemption and a non-refundable tax credit have differing values depending on the taxfiler's income level. This is a result of progressive MTRs, and the difference vanishes when considering a flat tax system. Under the flat tax plan, the provision of a $3,000 deduction per child is worth $510 in federal tax savings (0.17 x $3,000) for those families who have taxable incomes. These savings would be added to benefits currently received by families under the CTB, and they would be a new tax benefit for those at incomes above the levels that qualify for the CTB. However, the plan does nothing directly to correct the problem of very high MTRs that arise under the CTB scheme.[66] Indirectly, it does moderate the problem for these households who either become non-taxable because of the larger exemptions (thus dropping their federal tax rate by 17 percentage points) or are shifted into the flat 17 percent tax rate from the middle bracket. Nevertheless, some households would still face total MTRs of 60 percent or higher under the flat tax plan with an unreformed federal CTB and provincial benefits.[67]

A more satisfactory solution could be achieved under the current progressive federal tax and CTB scheme by instituting several reforms. The CTB payments could be subjected to considerably lower phase-out rates, which could be accomplished by: (1) lowering the incomes at which the phase-outs begin; (2) raising the income level at which the high phase-out rates of the National Child Benefit Supplement (part of the CTB) cease; and (3) stopping the phase-outs entirely above median family incomes. The last of these steps would leave in

place a flat dollar amount per child at the higher incomes, which would be a form of universal child benefit.[68] The largest benefits would continue to be directed to children in families at low and moderate incomes. Since the CTB would no longer vanish at high incomes, the phase-out rates could be correspondingly reduced, which means lower effective MTRs for beneficiaries. The phase-out rates of the reformed CTB would be completely eliminated above median family incomes — below $60,000 for two-parent families with children — so that they would no longer overlap the top federal MTR. A reformed scheme could also consolidate the GST tax credits for children with the CTB.[69]

There remains the question of whether a universal child benefit at high family incomes is economically desirable. It appears justified on the basis of horizontal equity, but is it economically efficient? One analysis has argued that it is inefficient to income-test such benefits, because this imposes different MTRs on households with and without children at the same income level.[70] Yet, providing any child benefits to families at above-average incomes raises the total revenue cost (even if it is an implicit cost via foregone taxes), thus necessitating higher MTRs than otherwise. Families at high incomes might well prefer a tax regime that offers no child benefits for them but lower MTRs. Providing child benefits to them serves as redistribution back to themselves across their lifetimes, since in other periods these households will no longer have children and will then be financing the benefits for others with children at the same income.[71] Thus, extending child benefits to higher-income families could entail efficiency costs, and this factor should moderate the size of such benefits and perhaps the choice of whether to provide them at all.

Simplicity of Flat and Dual Taxes

The analysis supporting the flat tax plan cites the standard trinity of criteria for tax policies — equity, efficiency, and simplicity — and then devotes substantial sections to the areas of equity and efficiency. In contrast, the goal of simplicity is cited at only a few limited points in the analysis. As noted before, the analysis invokes the simplicity criterion when preferring a single tax rate over joint taxation to address the issue of horizontal equity for one- and two-earner couples.[72] Yet, while the joint tax approach requires an additional tax rate schedule for married filers, it would otherwise achieve all of the same simplifications for tax and financial planning and compliance for couples. Claims made for the flat tax, which will be seen to extend substantially to the dual tax, include reduced opportunities for individuals to engage in tax-min-

imizing manoeuvres such as shifting incomes across time and family members. Both the flat and dual taxes offer additional potential for simplified tax withholding and personal-corporate tax integration that, surprisingly, were not exploited in these proposals.

The flat tax plan

The Alliance analysis states that, "In fact, an entire page of the current tax form would be eliminated, and [this change] would reduce resources expended by families trying to reduce the tax burden." This apparent reference to the federal tax calculation form ignores the fact that it would still be needed for calculating taxes, since even with the flat tax there would remain the dividend tax credit, foreign tax credits, computation of provincial taxes, taxes paid at source or via instalments, minimum tax carry-over, and various other tax credits. At most, a few lines would be saved in moving from a three-bracket rate schedule to a single tax rate; the savings would be even less with a dual tax. The form for the most recent tax year was already a bit simplified with the elimination of the general surtax, and it will be a bit further simplified when the high-income surtax is fully removed. Removal of the surtaxes will eliminate more lines from the form than would a shift to a flat tax. Regardless, this is a very minor dimension of tax simplification.

Any claims that might be made about radical simplifications from moving to a single rate of tax would be greatly overstated.[73] The practical complexity of the personal tax arises much more from its income base than from its progressive rate schedule. The flat and dual tax plans would do nothing to simplify the base of the tax. Existing complexities relating to the tax treatment of capital gains, depreciation of business assets (capital cost allowance), employee fringe benefits, interest expense, deductible business expenses, tax-deferred savings, and many other areas would remain. To deal with the most difficult of these issues (capital gains, depreciation, and interest expense) would require shifting the personal tax from its current "income" base (actually a hybrid between income and consumption) to a purer consumption or cash-flow base. Exactly that change was embodied in the seminal Hall-Rabushka flat tax proposal of the 1980s.[74] It would have shifted all taxation of capital incomes to a cash-flow basis and to the business level. Personal taxes would be applied at a flat rate above an exemption level solely to labour, public transfer, and miscellaneous incomes, but not capital incomes. Yet, a variant of this scheme has been devised that would operate with a progressive schedule of MTRs for individuals.[75] This demonstrates that the major simplifications arise from the shift to a cash-flow and consumption base and not from the flat tax rate itself.

The simplicity gains of the flat tax can be summarized as follows: eliminating the incentives and the need to police, via regulations and audits, the shifting of incomes, expenses, and assets across family members, tax years, and financial forms.[76] As for taxpayers' shifting income and expenses across tax years, with the flat tax there would continue to be an incentive to accelerate claims for deductible expenses and to defer the inclusion of taxable incomes. However, the flat tax would eliminate incentives to shift the timing of these items simply to obtain a lower average tax rate over several years. This kind of incentive arises with a progressive MTR schedule when there are no provisions for income averaging. Individuals with more variable incomes, such as those in business and entrepreneurial occupations, are penalized by being pushed into higher rate brackets in some years, without a full offset from being in lower rate brackets in other years. Ideally, a progressive income tax should offer liberal provisions for multi-year income averaging. There is a good basis in horizontal equity to reinstate a general averaging provision, which can be done easily in an era of computerized tax returns and tax administration.[77] Still, it must be granted that the flat tax offers a simpler solution.

The dual tax plan

The proposed dual tax plan also offers most of the same gains as the flat tax, because the proposed threshold for the higher rate is set at a figure of $100,000, far above the incomes of all but a few Canadians. For that reason, very few taxpayers will be in a position to shift incomes (over time or to a spouse) to reduce the effective tax on part of their income from the higher MTR of 25 percent to the basic MTR of 17 percent. In contrast, under the existing federal income tax, large numbers of taxpayers are in a position in at least some years to exploit the $30,000 and $60,000 thresholds between tax rate brackets through a variety of tax-minimizing actions. This also means that both the flat and dual tax would reduce the time needed to plan tax and financial affairs by many taxpayers. Nevertheless, it would be possible to achieve similar gains under a rate structure with much greater progressivity of MTRs with the implementation of joint filing and income-averaging provisions. Both of those features could be justified by horizontal equity considerations, although they do add a modest degree of complexity vis-à-vis the flat or dual tax solution.

Tax avoidance and tax arbitrage

A final distortion that might be moderated by a flat tax is tax avoidance and tax arbitrage. Tax avoidance consists of legal (or at least not overtly illegal) activities that maximize after-tax incomes by reducing taxable incomes. Usually

such activities distort the allocation of capital across the economy in ways that damage efficiency. The higher the MTR faced by an individual, the greater incentive there is to restructure financial assets, business arrangements, and real property to exploit intricacies of the tax law. Hence, the flat tax should moderate tax avoidance by its cuts to MTRs, steepest at the top end, even with an unchanged tax base and tax shelter provisions. Tax administration would be simplified and there would be less expenditure of private resources to plan and execute tax avoidance schemes. Of course, a similar but lesser moderation in tax avoidance could be achieved by lowering the top MTR in a progressive rate schedule; this is the approach used under the dual tax version. The flat tax plan's approach to tax avoidance, with its sharp cuts in progressivity, has been criticized as follows:

> *To reduce tax rates in order to reduce tax avoidance is akin to increasing speed limits in order to reduce speeding. It represents a confusion as to the objectives of the policy. To increase speed limits will reduce speeding (travelling at speeds exceeding the legal maximum) but will not reduce speed and it is* speed *which is the direct cause of accidents. ...What is needed is not relaxation of the law but more efficient policing of existing laws. In relation to taxation, the main aim of tax legislation is to raise revenue, not minimise the extent of tax avoidance...Other policies are available which will simultaneously reduce the extent of tax avoidance and increase tax revenue and these policies would not involve an unfair redistribution of the tax burden.*[78]

One particular type of tax avoidance is tax arbitrage, which is a situation where the taxpayer uses differential rates of tax to obtain some special tax advantage. Clearly, a flat tax with its single positive rate of tax should reduce the opportunities for tax arbitrage relative to a progressive MTR schedule.[79] Nevertheless, areas of tax arbitrage incentives would remain even with the flat tax plan. One notable example is the taxation of capital gains and the deductibility of interest expense. Interest incurred to finance investments is fully deductible,[80] but only a portion of any capital gain is included in tax. The flat tax plan proposes to retain this partial inclusion feature for capital gains and to reduce the inclusion rate further. Thus, even with a flat MTR, an individual can exploit a form of tax arbitrage by financing growth shares with debt, deducting the interest expense in full and reporting as taxable income only a portion of the gain. To correct this anomaly, the Canadian tax should institute further limitations on interest deductibility, following practices in the US and many other countries. This example illustrates the point

that a flat tax will share some problems of the existing progressive income tax unless appropriate remedies are made to its base.

Withholding of tax at source

Although the Alliance proposal did not describe these potential benefits, both the flat and dual tax schemes would lend themselves to improved withholding of tax at source as well as simpler integration of the personal and corporate tax systems.[81] Under the flat tax, withholding of taxes at source could be extended to a wider range of incomes, such as interest income, using the flat rate as the withholding rate. This approach would reduce the amount of income that goes unreported and untaxed in the hands of otherwise taxable individuals. With the dual tax, the rate of withholding could also be the basic rate (17 percent), since that affects the overwhelming proportion of taxpayers. The three percent of taxpayers facing the higher rate (25 percent) would then remit their additional taxes at filing time; this system would reduce the need for tax instalment payments by many taxpayers. Similarly, with a flat tax, personal and corporate taxes could be fully integrated — avoiding the double tax on dividends at the two levels — simply by making the receipt of Canadian dividends tax-free at the personal level; taxes on those sums would already have been collected at the corporate level. Of course, for perfect integration, this device would require aligning the corporate tax rate with the flat tax rate, necessitating an eventual cut in the federal general corporate tax rate to 17 percent. This system would also work for almost all taxpayers under the dual tax, but those facing the higher personal tax rate would owe additional tax on their dividends.

Credit income tax

One further provision would offer the ultimate in simplification with a flat or dual rate tax.[82] Instead of offering personal deductions for taxfiler, spouse, and children, these sums could be paid out to all persons on a universal basis. That is, with a flat tax of 17 percent, the $10,000 personal exemption would mean an annual payment of $1,700 (0.17 x $10,000) to every adult in Canada, likely divided into monthly sums; the proposed $3,000 deduction per child would translate into a further payment of $510 annually per child. These sums could be consolidated with payments of GST credits and Child Tax Benefits. Then taxes could be withheld at source at the flat rate on all major types of income, including wages, salaries, fringe benefits, interest, and public transfer payments (as described above, tax on dividends would already be withheld at the corporate level).

This system would eliminate the need to file tax returns for the great majority of individuals. Only persons receiving types of incomes not

amenable to source withholding — such as capital gain, self-employment, rental, and foreign-source incomes — would need to file a return.[83] Instead of claiming deductions on a personal tax return for items such as charitable contributions or savings in tax-recognized plans, the government would simply make matching payments to the charitable institutions and financial plan trustees based on their receipts. A dual tax could use the same approach but with more complexity due to the need to measure incomes to determine when individuals fell above the threshold for the higher tax rate. This approach was not discussed by the Canadian Alliance, possibly out of concern for appearing too radical and distaste for governments taking in more revenues and paying them back to taxpayers.[84]

Efficiency, Incentives, and Growth

Taxes and economic growth: cross-country comparisons

A common claim is that the size of a nation's total tax burden has a direct and significant impact on its incentives for efficiency and economic growth. This view underpins the Alliance tax proposal's goal of sharply cutting the federal tax burden relative to GDP.[85] Yet cross-country comparisons of economic performance and total tax burdens do not show any systematic relationship. Table 11 presents, for 25 OECD countries, figures on their increase in real GDP per capita for 1988–98 vis-à-vis their total taxes as a percentage of GDP for 1997. Clearly, both lightly and heavily taxed countries appear at both ends of the ranking of countries by their economic growth. The top six countries by economic growth include three with below-average taxes (Ireland, South Korea, and Portugal) and three with above-average taxes (Luxembourg, Norway, and the Netherlands). And the three with below-average taxes were also below average in per capita GDP at the beginning of the period, so that economic convergence may account for part of their outperformance. The two countries with the heaviest tax burdens, at around 50 percent of GDP, include one with average economic growth (Denmark) and one with sub-par growth (Sweden).

Careful statistical studies have attempted to sort out the impact of aggregate taxation and public spending on economic growth, using cross-country and time-series data.[86] Essentially, these studies have found no robust or significant relationship between aggregate tax levels and the rates of economic growth. Part of this may be related to the productivity of some forms of public spending. For example, it was found that the share of public investment in communications and transport facilities is positively correlated with growth rates. Hence, a government that taxes more but also spends its tax revenues productively may more than offset the potentially retarding effects of the taxes and actually contribute to economic growth. More

Table 11
Increase in Real GDP per Capita and Taxes as a % of GDP, 25 OECD Countries

Rank	Country	Increase in real GDP per capita, 1988-1998 (%)	Total taxes as a % of GDP, 1997
1	Ireland	92.2	32.8
2	South Korea	60.9	21.4
3	Luxembourg	41.2	46.5
4	Portugal	32.6	34.2
5	Norway	30.3	42.6
6	Netherlands	26.2	41.9
7	Spain	25.7	33.7
8	Denmark	21.8	49.5
9	Austria	21.7	44.3
10	Australia	20.4	29.8
11	Belgium	19.3	46.0
12	United States	18.5	29.7
13	Japan	16.8	28.8
14	Mexico	16.3	16.9
15	Greece	14.9	33.7
16	France	14.5	45.1
17	Germany	14.3	37.2
18	United Kingdom	14.0	35.4
19	Italy	13.5	44.4
20	Finland	13.4	46.5
21	Iceland	10.7	32.2
22	Sweden	7.3	51.9
23	New Zealand	5.7	36.4
24	Canada	5.0	36.8
25	Switzerland	4.9	33.8
	Average[a]	**22.5**	**37.3**

Note:
[a]Unweighted average of the 25 countries

Sources: Pierre Fortin, *The Canadian Standard of Living: Is There a Way Up?* Benefactors Lecture (Toronto: C.D. Howe Institute, October 1999), Table 1; Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965/1998* (Paris: OECD, . .99); the four poorest OECD countries — the Czech Republic, Hungary, Poland, and Turkey — are omitted.

importantly, studies that have distinguished among different types of taxes find that some types of taxes are much more adverse to economic growth than other types. In particular, it is found that taxes on capital income and savings are detrimental to long-run economic growth. In comparison, taxes based on consumption or labour income are much less adverse to growth. Based on the estimates in one recent study, decreasing the use of capital income taxes by five percent of GDP — even if fully offset by higher consumption or labour income taxes — would raise an economy's growth rate by 0.5 to one percent per year.[87]

Marginal efficiency costs of taxes

Table 12
Marginal Efficiency Costs of Alternative Tax Bases*

Tax base	MEC per $1 of tax
Sales value (consumption)	0.262
Labour income	0.376
All taxes together	0.391
Capital income at corporate level	0.448
Corporate plus individual income	0.497
Individual income (capital plus labour)	0.520
All capital income	0.675
Capital income at individual level	1.017

Note:
*These estimates are based on US data and the US Tax Reform Act of 1986.

Source: Dale W. Jorgensen and Kun-Young Yun, "The Excess Burden of Taxation in the United States," *Journal of Accounting, Auditing & Finance*, Vol. 6 (Fall 1991), pp. 487-508, at pp. 503-04.

A sizeable and growing body of theoretical economic studies, both qualitative analyses and quantitative models, further supports the conclusion that various types of tax bases carry different costs for economic efficiency and growth.[88] Table 12 presents the findings of one such study that breaks out the efficiency costs of taxes at the personal and corporate levels.[89] The real cost of a tax is measured by its "marginal efficiency cost" (MEC), which is the incremental cost in real resources of generating an extra dollar of tax revenues from a slight increase in the tax rate.[90] For example, an MEC of 0.10 would mean that collecting one extra dollar of tax revenues takes out of the economy not only that dollar but an additional 10 cents of

wasted or distorted resources. The table shows a clear ranking of the tax bases from lowest to highest MEC, one which is closely supported by most other studies on this topic. The most efficient (least inefficient) tax base is consumption or the value of a sales tax broadly applied to consumer goods and services; close behind is a payroll tax or personal tax on labour income. At the other end of the scale, taxes applied to capital income (or savings) are much more inefficient, and even more so when collected at the individual than at the corporate level. In the cited study, a personal tax on capital income has four times the MEC of a tax on consumption or sales. Hence, for a given total amount of tax revenues, an appropriate switch in the tax mix or reform of a tax base can reduce efficiency costs.

The reasons for the much higher efficiency costs of taxes on capital income and savings than of taxes on consumption or labour income are complex but can be translated into lay terms. Several economic processes operate simultaneously to produce this result. First, financial capital (and the tangible capital that it finances) is more mobile internationally than labour, which faces significant national barriers to movement. Capital is also much more mobile domestically in the sense that it can be switched into lesser-taxed forms such as owner-occupied housing or capital gains that are not realized for tax purposes. Labour income has far less scope for legal tax avoidance in response to higher tax rates. Savings and capital accumulation are also a critical component of long-run growth for an economy, and tax policies that retard them will affect the capital used by future workers and thus their productivity and real wages.[91] Even if savings for the economy as a whole are relatively unresponsive to changes in tax rates, imposing taxes on capital incomes and savings will distort individuals' time path of consumption over their lifetimes. They will choose inefficient mixes of current versus future levels of consumption, typically by saving less for their retirement, thus reducing their lifetime average levels of well-being.

The process by which a more consumption-oriented tax system promotes investment and economic growth involves several steps. First, tax provisions that treat savings in a more neutral manner than under an income tax, such as tax-registered savings plans, must induce individuals to save more. The empirical literature on this relationship finds a wide range of estimates, and it is generally recognized that the savings response is limited in part by the switching of previously held savings into tax-favoured forms. Nevertheless, many studies find that properly structured tax provisions do have the desired effect on aggregate savings.[92] If shifting the tax mix or tax base holds total tax revenue constant, then increased personal savings will raise total domestic savings. Yet, for the Canadian economy that is highly open to international capital flows, added savings can purchase foreign assets with no additional investment at home. Despite this fact, it is known

that high-saving countries also exhibit higher investment rates, which reflect the less-than-perfect mobility of capital. Moreover, lower tax rates on capital gains will stimulate saving and investing in forms that are uniquely important to economic growth — including stimulus to venture capital and seed equity for new domestic business formation and expansion.

The comparatively lower costs to economic efficiency and growth from taxing labour income can also be explained in non-technical terms.[93] Workers at low and median wage rates have been found to respond to changes in their net-of-tax wage rates — and hence to changes in the tax rate on their earnings — with only modest variations in their total work hours. The distortions to their labour supply from taxes are therefore relatively limited.[94] Workers at high wage rates or salaries are found to have almost no response in work hours following tax rate changes. In part, this follows the fact that highly paid workers, such as executives and professionals, are motivated largely by the intrinsic rewards and challenges of their work. Moreover, many of them already put in such long hours that it would be unrealistic for them to work even longer in response to tax rate

Table 13
Marginal Efficiency Costs of Higher Income Tax Rates, Canada and US

	MEC per $1 of tax*	
Jurisdiction	**Change in basic tax rate**	**Change in surtax rate**
British Columbia	0.46 to 1.03	63.80 to ∞
Ontario	0.62 to 1.61	3.59 to ∞
Quebec	0.99 to 3.88	69.43 to ∞
United States	2.06	3.76 to ∞

Note:
*For Canadian provinces, the two estimates for each type of tax rate change are based on different assumptions about the responsiveness of labour supply to tax rates. For the US, the basic rate refers to a proportionate increase in all MTRs; the surtax rate refers to the 1993 rate increases for high earners.

Sources: Canadian estimates from Bev Dahlby, "The Distortionary Effect of Rising Taxes," in W.B.P. Robson and W.M. Scarth (eds.), *Deficit Reduction: What Pain, What Gain?* (Toronto: C.D. Howe Institute, 1994), p. 63; US estimates from Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *Review of Economics and Statistics*, Vol. 81, no. 4 (November 1999), pp. 674-80.

cuts. Some highly paid workers would even respond to a rise in their after-tax pay by choosing to work fewer hours. As a result, cuts in tax rates on labour income, particularly the steep cuts for high earners that would arise with a flat rate tax, would yield little if any increase in productive work effort.

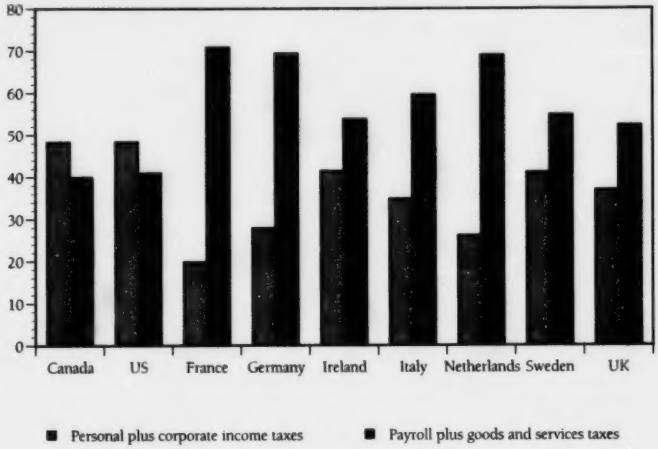
Calculations have been made for the MEC of raising revenues from the personal tax based solely on distortions in the labour market (and ignoring savings, the capital market, and long-run growth effects). Table 13 reports the findings for two such studies applied to Canada and the US, using data from the early 1990s. At that time, the top MTRs in some provinces approached the mid-50 percent range, including the provincial and federal rates and surtaxes. The range of estimates of MECs given in the table corresponds to alternative assumptions about the responsiveness of labour supply to tax rates. In the three cited provinces, the MEC from raising the basic provincial income tax rate ranges from about 0.5 to nearly 4. Raising the provinces' high-income surtax rates would have carried much higher MECs, ranging from 3.6 to infinity. In all of the surtax cases, including the cited US results, the MEC approaches infinity if the labour supply is fairly responsive to tax rates. This simply means that total revenues will be increased by a cut rather than a hike in the surtax rate, a so-called Laffer Curve response. Hence, it is not only the base for taxes but also the tax rate schedules that need to be considered in assessing efficiency costs. The evidence suggests that tax or surtax rates creating MTRs above 50 percent are particularly costly and should be curtailed.

The preceding discussion can be used to make sense of the cross-country patterns seen in Table 11. Countries can pursue tax policies that are relatively high without hampering growth if they choose a tax mix that stresses bases that are less deleterious to efficiency and growth. Table 14 shows the composition of taxes by major category for Canada, the US, and seven major European countries. As a general proposition, the less-distorting taxes are ones on consumption (goods and services) and on labour income (payroll); the more-distorting taxes apply to capital as well as labour income, namely the personal and corporate income taxes. The figures by country are aggregated into those two groups of taxes and shown in Figure 5. Canada and the US stand out from their European counterparts as being relatively much more reliant on income taxes and much less reliant on the lower-distorting payroll and goods and services taxes. This may help to explain why some of the heavily taxed European countries have nevertheless surpassed both Canada and the US in their longer-run growth.

Consumption-oriented income taxes

The story becomes more nuanced when we consider that a personal "income" tax can in fact vary sharply in the degree to which it taxes total income

Figure 5
Composition of Tax Revenues, Canada and Selected OECD Countries, 1997



vis-à-vis mainly labour income and/or consumption. Through various tax deductions or exemptions or preferential rates for savings, capital gains, and other forms of capital income, a personal tax base can be closer to consumption. The Canadian personal tax is mainly a consumption-based tax for nearly 95 percent of taxpayers, those with incomes below $75,000. Up to that income level, almost all savings can be undertaken in a form that is effectively tax-sheltered through registered savings plans.[95] And the other major form of personal savings — investment in one's home — also enjoys tax-free treatment on any capital gains. Only for higher earners does the Canadian tax system act as a tax on personal income, including much capital income. Thus, a very different standard of horizontal equity is applied for measuring taxpayers' "ability to pay" at low and middle incomes than for those at upper incomes.

Similarly, one must consider not only the formal mix of taxes used by other OECD countries but also the provisions in their personal taxes that are more consumption-oriented than Canada's at higher incomes. For example, on the matter of tax-sheltered registered savings, the UK allows far more liberal access to tax-recognized savings than does Canada. A Briton can contribute annually to a tax-deferred savings plan along with his employer up to 17.5 percent of earnings to an earnings maximum in 1999–2000 of £90,600 (nearly C$190,000; the amount is fully indexed for inflation). In addition, he or she can contribute up to another £5,000 (C$10,400) per year independent of earn-

Table 14
Mix of Tax Revenues, Canada, US and Selected European Countries, 1997

	Tax as % of total taxes[d]								
Type of tax	**Canada**	**France**	**Germany**	**Ireland**	**Italy**	**Netherlands**	**Sweden**	**UK**	**US**
Personal income	38.0	14.0	23.9	31.4	25.3	15.6	35.0	24.8	39.0
Corporate income	10.3	5.8	4.0	10.0	9.5	10.5	6.1	12.1	9.4
Payroll[a]	15.5	43.0	41.6	14.0	33.6	40.9	32.4	17.2	24.2
Goods and services[b]	24.4	27.8	27.7	39.7	25.9	28.0	22.3	35.0	16.7
Property[c]	10.0	5.4	2.7	4.9	5.1	4.6	3.9	10.8	10.7
Taxes as % of GDP	**36.8**	**45.1**	**37.2**	**32.8**	**44.4**	**41.9**	**51.9**	**35.4**	**29.7**

Notes:
[a] Includes social security contributions as well as general payroll taxes
[b] Includes general sales taxes (retail taxes, GST/VAT) as well as excise taxes
[c] Includes taxes on wealth and estates as well as real estate
[d] Totals do not always add up to 100 percent because of rounding error and minor omitted tax types

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics*, 1965/1998 (Paris: OECD, 1999).

ings to a tax-prepaid scheme called an Individual Savings Account. Moreover, capital gains are given highly preferential tax treatment in a number of countries. For example, Britain exempts the first £7,200 (nearly C$15,000) of each taxpayer's annual capital gains, and the Netherlands exempts all capital gains from tax. Scandinavian countries recognize the differential mobility and efficiency costs of taxing capital and labour incomes by applying separate tax schedules to each. Sweden, for example, taxes labour income at progressive personal rates, rising to a top MTR of 51 percent, whereas capital income faces a flat tax rate of just 30 percent. And Ireland has been much cited for its very low tax rates on capital income at the corporate level.

Differences in the personal tax base may be as important as differences in personal tax rates when comparing Canada with the US. The US, with a below-average tax burden as seen in Table 11, experienced economic growth just below the OECD average, while Canada, with only an average tax burden, has suffered growth far below the average. The US tax system allows much larger access to tax-recognized savings than does Canada, particularly at upper-income levels. For example, 401(k) qualified cash plans allow up to US$10,500 of tax-deductible contributions per worker in 2000; defined-contribution plans allow up to 25 percent of earnings or US$30,000 (more than triple the equivalent dollar limit for Canadian tax-deferred plans). In addition, the US offers a system of individual retirement accounts (IRAs) with annual contributions of up to US$2,000 on either a tax-deferred or a tax-prepaid basis; this amount would rise to US$5,000 by 2003 under a bill recently approved by the Senate Finance Committee. The US also offers effective tax rates on realized long-term capital gains (assets held for at least one year) that are below those in Canada (see Table 5 for a comparison of top MTRs), although Canadian tax rates on short-term gains are well below those in the US. Note that the US economy's outperformance relative to Canada's in the 1988–98 period arose despite sharp increases in US federal tax rates on high earners in 1990 and 1993 (noted earlier), which were combined with cuts to the effective tax rates on long-term capital gains.

What can be learned from the economic studies and comparative international experience is that taxing "smarter" is more important than taxing less when promoting economic growth. Either shifting the total revenue mix toward greater reliance on indirect taxes on goods and services or on payroll-type taxes, or reforming the personal tax base to be more consumption-oriented and less reliant on savings and capital incomes, would pay significant economic dividends. If one is concerned about the vertical equity of the overall tax system, the latter set of reforms is preferable to the former. Sales-type taxes and payroll taxes

are typically found to be regressive, even in a lifetime perspective. In contrast, a personal tax can retain as much progressivity of the MTR schedule as desired, even while shifting its base further from income and closer to labour income and consumption. Additionally, there is evidence that personal surtax rates yielding total MTRs above 50 percent are particularly costly to the economy. In the Canadian context, this problem would be addressed by removing the federal high-income surtax (lopping 1.45 percentage points off the top total MTR) and, more importantly, by reducing or removing the surtaxes applied by some provinces (which add up to 6.5 percentage points to top MTRs).

Shifting the personal tax base further toward consumption for a wider spectrum of earners would also improve the lifetime horizontal equity of the tax system. Consider the situation of two workers who hold identical jobs in the same firm throughout their lives, both earning the same salaries in each year. They do not differ in any other attributes such as age, family status, skills, or effort. Thus the two are fully equal in their lifetime *opportunities* to consume, but they do differ in one key respect. "Spender" spends all of every paycheque by the next payday, whereas "Saver" saves a part of each paycheque toward retirement. Spender therefore accumulates no savings, never receives any capital income, and enters retirement with no assets. In contrast, Saver earns capital income that grows every year and enters retirement with substantial assets. If one regards the two individuals' identical labour earnings (and opportunities to consume) as making them similar in ability to pay, then horizontal equity implies that they should bear the same total tax burdens over their lives. In this view, horizontal equity would be satisfied by a consumption-based tax, using either actual consumption or labour earnings in each year. In contrast, an income-based tax assumes that Saver has a higher total lifetime ability to pay tax and penalizes the thrift through a heavier lifetime tax burden that includes capital income on savings.

One common critique of shifting the personal tax base further toward consumption at higher income levels is that it would reduce the vertical equity or effective progressivity of the tax system. This observation is correct in an annual perspective, since wealth, savings, and capital incomes are heavily concentrated in high-income groups. Yet, compared with the alternative strategy of simply eliminating all MTR progressivity by instituting a single rate tax, a policy of shifting the personal tax base further toward consumption for high earners while retaining a progressive MTR schedule is far less damaging to vertical equity. Moreover, this critique of tax provisions for savings on vertical equity grounds is short-sighted in its focus on the immediate distributional effects of tax policy. Augmented savings will set in motion a series of longer-run effects on the real

economy, which in turn affect distributional outcomes. A recent analysis based on firms' choices among technologies helps explain the patterns of skill premiums for workers (university graduates relative to those with only high-school education) as well as the patterns of productivity growth for Canada and the US. It finds that tax or other policies that spur savings and capital accumulation will raise skilled wages, but raise unskilled wages even more, thus compressing the skill premium and reducing inequality.[96] In this manner, greater tax recognition of savings would promote greater equality in the distribution of labour earnings over the intermediate to long run.

Fiscal Aspects of Flat and Dual Taxes

The flat tax and dual tax plans raise several broader questions of fiscal policy. First, can each plan be "afforded" by Canada, and are the underlying estimates of cost and economic impact reasonably reliable, or do they assume unrealistic economic and revenue effects? Second, can the shift from a flat tax to a dual tax plan, even if transitional, be explained by fiscal affordability? Third, how does each plan fit into Canadians' other priorities for the federal surplus, including program spending, debt reduction, and alternative forms of tax cuts? In particular, how do the tax plans relate to the Alliance's goals for federal spending restraint? Fourth, how might the spending side of the fiscal plan combine with the taxation side to affect the more vulnerable groups in society? All these questions involve not only issues of economic behaviour but also individual values concerning the size and scope of government, the distribution of taxes and public benefits, and matters of intergenerational equity.

Affordability of the tax plans

The flat and dual tax plans have been tailored to fit the projected fiscal surpluses of the next five years. For the original flat tax plan, that was the period through fiscal year 2004–05; for the later dual tax plan, the period runs through 2005–06. Each plan is based on projections of the economy, revenues, and budgetary surpluses published by the federal Finance Department, using estimates by private sector forecasters and updated by analysts at WEFA Inc. to reflect later economic developments.[97] Each plan assumes a phased implementation of the tax parameters; the schedule for the latest version including the dual tax is shown in Table 15. Most of the tax changes are staged in roughly equal parts for each of the years, except that in the first year the high-income surtax would be eliminated and the tax inclusion rate for capital gains reduced to 50 percent. It is notable that the increased foreign content limit on registered savings plans would not be eliminat-

Table 15
Planned Implementation Schedule of the Canadian Alliance's Tax Plan[a]

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07[c]
Income tax thresholds							
Basic amount for credit	7,231	7,600	8,200	8,800	9,400	10,000	[b]
Spousal amount for credit	6,140	7,600	8,200	8,800	9,400	10,000	[b]
Child deduction	0	1,000	1,500	2,000	2,500	3,000	[b]
Middle tax threshold	30,004	[b]	[b]	[b]	35,000	n/a	n/a
Top tax threshold	60,009	[b]	[b]	[b]	70,000	100,000	n/a
Marginal tax rates							
Middle tax rate (percent)	24	23	22	21	20	17	n/a
Top tax rate (percent)	29	28	28	27	27	25	17
Surtax rate (percent)	4	0	0	0	0	0	0
RPP/RRSPs							
Max. contribution	13,500	13,500	13,500	14,500	15,500	16,500	[b]
Percent of income	18	20	22	24	26	30	30
Foreign content limit (percent)	25	30	40	60	80	100	100
Capital gains							
Inclusion rate (percent)	66.67	50	50	50	50	50	50

Table 15 (continued)
Planned Implementation Schedule of the Canadian Alliance's Tax Plan[a]

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
EI premiums							
Rate per $100, employees	2.40	2.30	2.20	2.10	2.00	2.00	2.00
Business taxes							
General corporate tax rate (percent)	28	27	25	23	21	21	21
Small business rate, income < $200K, (percent)	12	12	12	11	10.5	10	10
Income from $200K to $300K (percent)	28	21	21	21	21	21	21

Notes:
[a] Schedule for the amended plan including transitional dual rate tax, assuming that implementation begins with a federal budget in early 2001.
[b] Figures are indexed for inflation from previous year's figure.
[c] This timing for the shift to a flat tax is inferred from statements of Canadian Alliance leader (note 6 to text). The other dollar figures for fiscal 2006-07 are indexed amounts from 2005-06.

Source: Dale Orr and Bob Dugan, "Economic and Fiscal Impact of Canadian Alliance Proposals for Tax Reduction: Update," Ottawa, WEFA Inc., September 2000, mimeo and material provided by the Canadian Alliance.

ed immediately, that the dollar limit on contributions would not begin to increase until 2003–04, and that the initial cut of the general corporate tax rate to 27 percent in 2001–02 is no more than announced in the federal budget of 2000.

The latest Alliance fiscal plan would entail a projected total loss of federal tax revenues of $66 billion over the five years ending 2005–06. This sum is above and beyond the revenue cost of $58 billion from the government's planned tax cuts over the five years through 2004–05 as set out in the 2000 budget.[98] In 2005–06, the dual tax plan carries an incremental revenue cost of $22.6 billion assuming no economic stimulus from the package; this is somewhat over 10 percent of total federal revenues. This net fiscal cost is offset by $1.8 billion of revenue gains from the estimated stimulus to the economy but increased by $5 billion in additional debt charges due to diversion of the fiscal surplus from debt reduction to additional tax reduction. The net impact of the tax plan on the fiscal balance in 2005–06 is about $26 billion. The bulk of the revenue cost stems from the personal tax cuts rather than the business tax cuts.[99] The estimates underlying the forecasts have been done conservatively and allow for a margin of error in the economy's future performance. The analysts avoid making heroic assumptions about the revenue effects of lower tax rates, although their economic and fiscal projections assume modest supply-side effects of the plan. The economic literature on this topic is quite divided, with some analysts finding large and possibly fully offsetting revenue effects from tax rate cuts, particularly for high-income taxpayers and capital gains.[100] Other analysts find these estimated effects to be transitory or spurious.[101] In short, using the Alliance's own assumptions about their future spending, debt repayment, and taxing intentions, their dual tax plan appears to be affordable over the planned period.

Can the Alliance's policy shift from a flat tax to a dual tax, at least in a first electoral mandate, be explained by their choice to make room for less spending restraint and more rapid debt reduction? On the basis of their own fiscal projections, this does not appear to be the case. Between the time of the party's original plan and their electoral platform, official reports confirmed much larger federal fiscal surpluses than previously forecast. If anything, this added fiscal leeway would have widened the options for tax cuts rather than narrowing them. Even with its recently enlarged commitments for debt reduction and much less constrained spending growth, the plan projects that there will be available additional surplus funds ranging from $7 billion to $12 billion per year between 2001–02 and 2005–6.[102] These figures already include the impact of the dual tax plan and faster debt reduction, so that these funds could finance more or faster tax cuts, more federal spending, or larger debt repayment. The Canadian Alliance

has now committed to increasing transfers for health care faster than in their original plan, and this will consume part of the additional surplus funds. But there still would be room for the net revenue cost of going from the dual tax to the flat tax, which we earlier estimated at $2.4 billion for 2000. The corresponding figure for 2005–6 would likely grow to just over $3 billion. Hence the remaining "extra" surplus under the proposed plan would suffice to move forward more rapidly with the full flat tax, if this were a high priority. Any explanation for the proposed delay in its implementation, therefore, is not the result of fiscal unfeasibility.

Desirability of the tax plans

While prudent budgeting suggests that the dual or flat tax plan is affordable over the planned time frame, there are other basic questions worth reflecting upon. Are these tax cuts the best use of the projected fiscal surpluses, or would part of the funds be better applied to more program spending, faster debt reduction, and/or other forms of tax cuts? This question can only be answered relative to individual values, but a few observations are apropos. For instance, the Alliance proposal suggests that, "while there certainly are high priority public policy needs such as health, education, and defence that deserve further spending increases, this can be achieved through a reallocation from within the existing spending envelope."[103] To illustrate where the funds might come from, the plan cites "wasteful programs" such as "all grants to special interest groups and big business through the Departments of Canadian Heritage and Industry. We will trim back the wasteful bureaucracies that currently exist in the CRTC and Indian Affairs."[104] The party has also signalled its intentions to cut back on Employment Insurance, at least the "regional subsidy" component of the program.[105] Yet, even accepting that there is remediable waste in many programs, questions arise as to the magnitude of waste and the real-world effects on various beneficiary groups from cutting programs.

A key element of the Alliance fiscal plan is sustained restraint on federal program spending over five years. However, there is a big difference between the original plan released in early 2000 and the revised version of October 2000. The original plan allowed federal program spending to increase only $1 billion per year, less than one percent per annum, to reflect the growth of the Canadian population. It did not allow any increases even for inflation in the cost of operating public programs; it asserted that the rising costs of running priority programs would be covered by cuts to less-favoured programs. Over five years, this plan would have cumulated to a 10 percent reduction in real federal program spending per capita, assuming that inflation runs about two percent per year. With gross domestic prod-

uct projected to rise at over three percent per annum in real terms, this level of restraint would see federal spending decline sharply as a percentage of GDP. The 1990s have already witnessed total government spending as percentage of GDP fall more rapidly in Canada than in any other G-7 country, by 8.3 percentage points from 1992 to 1998;[106] the Canadian figure is now slightly below the G-7 average. In contrast, the revised Alliance plan provides an average 2.5 percent growth rate in program spending over the five-year period, not far short of the projected three percent needed to maintain total per capita spending in real terms.

In spite of the considerably relaxed spending restraint in the revised policy package, it does diverge from the likely path of the current government, which would see part of rising real national output devoted to enhanced public services. Large areas of federal spending will be under strong pressures to grow even more rapidly than general rises in the price level and population. Of the $116 billion in the federal budget for 2000–01 for program spending, fully half falls into those kinds of envelopes. Major transfers to persons take $36 billion (of which $24.2 billion are elderly benefits, fully indexed for inflation, and a beneficiary group growing faster than the population), and cash transfers to other government levels take another $22.6 billion. The latter category includes the Canada Health and Social Transfer, which is already committed to grow far faster than inflation plus population to restore earlier cuts in health care and education financing to the provinces. The Alliance has pledged to raise these transfers by even more than the recent federal commitments. Of the remaining spending areas, the Alliance has pledged sharp hikes ($2 billion per year) for defence outlays (currently $9.4 billion per year). As a consequence, to achieve its tax cuts and also allow large and growing sums for debt repayment, the Alliance plan would have to make deep cuts in real spending for most of the remaining program areas.

One might also give higher priority to a more rapid reduction of public debt than that planned by the Alliance or the current government.[107] This approach would ensure the sustainability of both enhanced public services *and* lower taxes in future years, and it would be more equitable to future generations who will have to finance the needs of retiring baby boomers. With its electoral platform, the Alliance has ramped up its debt repayment goal to at least $6 billion per year in addition to the government's annual $3 billion contingency reserves; it also promises legislation to have 75 percent of unanticipated surpluses devoted to debt reduction. Still, given the high levels of public debt in Canada at both the federal and provincial levels, even more rapid debt repayment might bring long-run benefits. Repayment of public debt is a source of national savings that can increase the economy's long-run growth, similar to increased private savings. At the same time, one must be wary of the long-run distribu-

tional implications of a faster debt repayment strategy. If the goal is to have smaller government and lower taxes both today and in future years, lower-income groups may never see any benefits from enhanced programs.

The benefits of tax cuts for low- and moderate-income taxpayers have been stressed in the Alliance plan. However, the potential impacts of constrained federal program spending are likely more important for groups at those income levels. In thinking about this issue, one must recall the size of the tax savings for lower-income households. For a taxable single person with income below $30,000, the savings are a flat $471 per year; for a two-earner couple each with earnings below $30,000, the combined savings are a flat $942 (2 x $471); and for a one-earner couple or single parent, the combined savings are a flat $1,127 ($471 plus 0.17 x ($10,000 – $6,140)). In addition, there will be savings of $510 per child with the proposed new child deductions of $3,000. Individuals at the lowest incomes are non-taxable and will gain nothing from the tax cuts, and those at somewhat higher incomes will be shifted from taxable to non-taxable status and will gain only a portion of the cited sums. Such groups stand to lose much more than their flat tax savings from the related cuts to or restraints on growth of public programs. These lost program benefits will equal the average tax savings per taxpayer or family, which are much larger than the tax savings for individuals at lower incomes (see Table 6). This result stems from the highly disproportionate loss of revenue from taxpayers at above-average incomes — more so with the flat tax than with the dual tax. Of course, if the spending restraint can be confined to truly "wasteful" spending with no impact on the end beneficiaries, then these effects will not arise.

Companion Tax Changes

The Alliance's tax proposal includes other elements besides the flat and dual income tax rates, the enlarged exemptions for filer and married/equivalent status, and the new child deduction. Several of these items are part of the personal income tax: changes to registered savings plans (RRSPs and Registered Pension Plans) plus full indexation of the personal tax. The other items are rate cuts for Employment Insurance and the federal corporate income tax. All of these suggested changes mirror proposals that others have advanced and assessed previously. Hence, earlier analyses can be referenced for arguments supporting or opposing the proposed companion changes for the Alliance tax plan. Indeed, most of these items have already been accepted as necessary tax

changes by the federal government, which has committed itself to implementing them in some form over the next five years, as well as by some other opposition parties.

Registered savings plans

The Alliance Party proposes three changes to the operation of registered savings plans. First, the maximum allowable contributions (employer, employee, plus individual) would be raised from the current limit of 18 percent of earned income to 30 percent. Second, the annual maximum on contributions would be lifted from the current $13,500 to $16,500. Third, the limit on foreign holdings in registered savings plans would be raised and eliminated over five years. Official policy has already begun to tackle the last of these proposals; the federal budget of 2000 raised the then-existing 20 percent limit on foreign holdings in registered plans to 25 percent for 2000 and to 30 percent for 2001. Several analyses of the foreign asset limit have demonstrated beyond question that the limit is ineffective in practice (given the development of derivative financial instruments that allow investors to skirt the limit), costly to individuals saving for their retirement, and of no benefit to either the Canadian economy or the federal treasury.[108] For these reasons, it would be sensible policy to eliminate the foreign asset limit immediately.

The proposed hike in contribution limits for registered savings plans would benefit upper-middle income Canadians almost exclusively. The current limits of 18 percent and $13,500 mean that individuals are constrained in their tax-recognized savings only for annual earnings above $75,000. The Alliance argues that, "This increase in the relative [percentage] amount [from 18 to 30 percent of earnings] will help low and middle income Canadians the most." However, the evidence is that very few low- and middle-income Canadians now use all their allowable room for contributions, so raising the percentage limit would be of little benefit to them.[109] Moreover, the Canadian system for tax-recognized savings permits individuals to carry forward any unused contribution space, and anyone who saves as much as 18 percent of their lifetime labour earnings will be prepared for a retirement that sustains their accustomed living standards. There is thus little rationale for raising the 18 percent limit. The dollar ceiling on contributions is a barrier, though, for many higher earners and is low relative to the limits in countries such as the US and the UK. One could justify a large rise in the dollar limit based on tax competitiveness as well as incentives for savings and economic growth; the federal government already appears committed to make at least modest hikes in the dollar limit.[110] Yet a superior approach would be to restructure the method of taxing retirement savings, as detailed in the later section offering a tax policy alternative to the Alliance tax package.

Indexation of personal income tax

The flat tax plan pledged to make the personal income tax fully indexed for inflation. This proposal was made prior to the 2000 federal budget, which restored full indexation to the income tax system. But the federal actions in this area may also owe something to the example set by Alberta, which in its 1999 budget committed to fully index the provincial income tax. Under a flat tax, there is no need to index tax brackets since there is just one; only the exemptions that are provided for filers, spouses, and dependants need to be indexed. The Alberta flat tax to begin in 2001 will go much further than just undoing the damage from incomplete indexing of taxes since 1986. It will raise the basic exemption from $7,231, and the spousal exemption from $6,140, both to a common value of $11,620. The Alliance flat and dual tax plans would not go as far but would still offer a substantial hike in both exemption values to $10,000. Full indexation of the tax system is widely accepted as both equitable and a desirable restraint against arbitrary hidden tax increases; less than full indexation is particularly burdensome for low- and modest-income taxpayers.[111]

Employment Insurance premiums

The Alliance proposes that the employee premium rate for Employment Insurance be reduced from its current rate of $2.40 per $100 of earnings to $2.00.[112] Federal budget papers for 2000 indicate that the government is on course toward a similar objective: "For planning purposes, employee EI premium rates are assumed to decline by 10 cents in 2001, 2002 and 2003. Actual rates are set each year by the Employment Insurance Commission."[113] It also projects future tax reductions assuming a further 10 cent rate cut for employee EI premiums in 2004, which would achieve the Alliance target rate of $2.00 in that year.[114] The government recently announced plans to cut the EI rate a bit faster, by 15 cents for 2001. Nevertheless, there are good arguments for undertaking a much faster cut in EI premium rates.[115] The EI Account already has accumulated a massive surplus, and EI premiums that are above those needed to finance the program's operation act as a general payroll tax that may inhibit employment, at least in the short run. Moreover, with a $39,000 ceiling on taxed earnings, excess premiums are a highly regressive way of collecting general revenues for the federal treasury. Lower employee EI rates will directly raise workers' paycheques, and the related cut in employer EI rates (fixed at 1.4 times the employee rate) will eventually flow through as higher wages and salaries for low- and median-income workers.

Federal corporate income tax rates

The last major element of the Alliance tax package is a cut in the federal corporate income tax rates. It recommends a cut in the general corporate rate from 28 percent to the 21 percent already enjoyed by Canadian firms in the manufacturing, processing, and resource sectors. This would level the playing field across sectors of the economy and encourage greater investment in the high-growth tech and service sectors. It also recommends a cut in the small corporate tax rate from 12 percent to 10 percent. The need for these changes, especially the cut in the general corporate tax rate, is already widely acknowledged by tax analysts and advocates in Canada. A cut and leveling of corporate tax rates was urged by the Technical Committee on Business Taxation appointed by the Department of Finance.[116] This policy has also been supported by groups as disparate as the C.D. Howe Institute and the Canadian Auto Workers. The federal budget of 2000 committed the government to cutting the corporate tax rate to 21 percent within five years. Indeed, a strong case can be made for a more rapid cut in this rate, even at the cost of slower personal tax cuts, followed by further cuts in corporate tax rates to bring them below US rates.[117] The cuts in Irish corporate tax rates are often cited as an example of the potential economic returns to this strategy.[118]

A "Model" Tax Plan

Drawing on the preceding analysis of comparative US tax rates, progressivity, horizontal equity, tax simplicity, tax aspects of efficiency and growth, and the European tax experience, one can formulate a tax policy alternative to the Alliance tax plan.[119] The objective of this "Model" tax plan is to achieve greater economic efficiency, growth stimulus, and horizontal equity at lesser cost in vertical equity and tax revenues. We develop a strategy based on the theme of taxing "smarter" as well as taxing less; a smart tax policy will focus cuts in areas yielding the best economic returns, with due attention to matters of tax equity and simplicity.[120] Based on the earlier evidence, it is economically efficient to cut the effective tax rates on savings and capital incomes more than on labour incomes. The Model tax plan begins with the corporate income tax and EI premiums but then focuses on the personal income tax.

Corporate income taxes and Employment Insurance premiums

Cuts to the corporate income tax and EI premium rates are part of the Alliance flat tax plan, but they involve small revenues relative to the personal tax cuts. When fully implemented, the corporate tax cuts will cost $2.2 billion per

year and the EI cuts $2.7 billion, as against about $26 billion for the personal tax cuts — all figures relative to the pre-2000-budget situation.[121] The Model tax plan would expedite both the corporate and EI cuts to be completed within two years as against the Alliance's five-year time frame. It would use the same 21 percent rate as an immediate target for the general corporate tax rate but would then aim for further cuts in subsequent years to bring rates below those in the US. Relative to revenue cost, this is likely to bring the greatest economic benefits to Canada in terms of productive investment and job creation. It is also the element, along with reduced capital gains taxes, that is most likely to generate large offsetting growth in tax revenues. However, the Model tax plan would not follow the Alliance plan in cutting the small business corporate tax rate from 12 percent to 10 percent. The goal of tax policy in this area should be to level the playing field among all types of businesses, for reasons of equity as well as efficiency.

A rapid cut in EI premiums for employees would flow directly into higher take-home pay and be concentrated on workers earning below the $39,000 ceiling for premiums; workers with higher earnings would receive a lump-sum boost to their take-home pay. This change would be the most progressive form of tax cut other than increases in the basic credits of the personal income tax. The current excess premiums charged for EI relative to the financial needs of the program are the most regressive element of federal tax policy in recent years aside from incomplete indexing of personal taxes. These excess premiums are a form of general revenue for the federal government, as they flow into the consolidated revenue fund. This raises revenues in arbitrary ways, such as taxing employed workers while exempting the self-employed and those with unearned incomes. The parallel cut in EI premiums for employers would, in the short run, raise the demand for less-skilled labour, and in the long run these savings would be shifted into higher worker pay. Cutting EI premium rates is desirable even though, as noted earlier, labour income is a relatively efficient base for taxation. A personal tax base modified to de-emphasize capital income offers a more attractive way to tax labour income, because it can apply a basic exemption and progressive rates rather than the flat rate and ceiling of a conventional payroll tax.

Personal income tax credits and deductions

The basic and spousal/equivalent-to-spousal tax credits used to relieve lower-income taxpayers should be substantially increased, beyond the increases already announced in the last two federal budgets. Feasible objectives for these credits would be at least $9,000 for the basic credit and at least $7,500 for the spousal/equivalent credit, both within three years. These figures would more than fully offset the incomplete indexation since 1986, though they would fall

short of the $10,000 targets set by the flat and dual tax plans for both credits. A reason to maintain a differential between the two types of credits is the scale economies that couples (or single parents) can achieve relative to single persons; this serves to promote horizontal equity. The Model tax plan would not follow the flat or dual tax with a $3,000 tax deduction per child but would achieve a similar objective by extending Child Tax Benefits into a universal benefit at above-median incomes. This approach would achieve several things absent in the flat or dual tax: avoid duplicating benefits for families at low and moderate incomes; bring greater simplicity to the tax-transfer system; and allow meaningful cuts in the Child Tax Benefit taxback rates at lower incomes. The tax credit now granted for aged taxfilers would be removed, as it gives seniors an unfair advantage over non-aged persons at the same incomes, thus violating horizontal equity.[122] The Alliance plan is silent as to its approach on the age credits.

Personal income tax schedule

As far as the federal income tax brackets and rates, the Model tax plan would seek to undo the damage of inflation on an inadequately indexed system and also to make the Canadian system competitive with the US for upper-middle earners in the high-tech and knowledge sectors. The bottom-rate bracket would be widened from its current $30,000 to about $40,000; its 17 percent tax rate would be left unchanged. This change would eliminate most problems of overlap between the middle-tax bracket and the high taxback rates of the Child Tax Benefit. The middle-rate bracket would then begin at $40,000 and its upper bound would be doubled to about $120,000. The 26 percent rate of the middle bracket prior to the federal budget of 2000 was too high for reasons of incentive and efficiency. Reducing this to a rate of around 23 percent would be a suitable target. Expanding the income range for the middle tax-rate bracket would go a long way toward improving the competitive position of the Canadian tax system vis-à-vis the US. It would also help to relieve the existing relative tax burden faced by one-earner couples in Canada, as shown earlier in Figure 2, although an income splitting or joint filing provision would be needed for a full remedy of this disadvantage.[123]

As seen from the earlier evidence, the top *federal* MTR is not a problem for Canadian tax competitiveness, other than the relatively low income level at which it applies. With the proposed changes, the top bracket would begin at $120,000 and apply to all higher incomes. There are no impelling reasons to reduce the top rate from its present 29 percent, other than a quick elimination of the high-income surtax (which would reduce the effective top MTR by 1.45 percentage points). Yet there is nothing magic about keeping three federal tax brack-

Table 16
Comparative Federal MTRs of Flat Tax, Dual Tax, and Model Tax and Cuts Relative to January 2000 Federal Tax Rates[a]

Taxable income range ($)	Federal MTR (%)	New federal MTR (%)			Cut in federal MTR (% points)		
		Flat tax	Dual tax	Model tax	Flat tax	Dual tax	Model tax
Less than 30,000	17	17	17	17	0	0	0
30,000-40,000	26	17	17	17	9	9	9
40,000-60,000	26	17	17	23	9	9	3
60,000-65,000	29	17	17	23	12	12	6
65,000-100,000	30.45	17	17	23	13.45	13.45	7.45
100,000-120,000	30.45	17	25	23	13.45	5.45	7.45
120,000 and over	30.45	17	25	29	13.45	5.45	1.45

Note:
[a]These comparisons use the parameters of the federal tax system prior to the 2000 budget, which began a series of cuts to the middle-bracket tax rate and increased the threshold for the high-income surtax; income ranges are rounded to nearest $1,000.

Source: Author's calculations.

ets. One analyst has suggested that a fourth bracket be added if the government faces resistance in cutting the 29 percent federal rate for upper-middle earners.[124] Table 16 shows the resulting tax rates for the Model tax and the flat and dual taxes as well as the rate cuts relative to the federal rates at the beginning of 2000. The flat tax would cut MTRs the most for the highest incomes; the dual tax would cut MTRs the most for individual incomes from $65,000 to $100,000; and the Model tax would cut MTRs the most in the $30,000 to $40,000 income range and second most for the $65,000 to $120,000 range.[125] In contrast to the flat tax, which would cut the MTR most sharply for those at the highest incomes, the Model tax would give that group the smallest cut in MTRs (other than the lowest income group, for which all schemes would leave the tax rate unchanged at 17 percent).

If there is any problem with top MTRs in Canada, other than their starting incomes, it arises from provincial rather than federal policies.[126] Several provinces impose high-income surtaxes that raise the total MTRs of high earners significantly. For example, BC and Ontario impose such surtaxes, the latter under the name of the "Fair Share Health Care Levy." By 2003, Saskatchewan will have reduced its top MTR from the current 19.3 percent to 15 percent, which will apply only to incomes over $100,000. The other provinces might be well advised to follow Saskatchewan's example and moderate or abolish their surtax rates. Then the top MTRs would fall below 45 percent, and only a small proportion of taxpayers would be exposed to them. Two other provisions should be added to the federal tax along with the recommended rate and bracket changes: liberal income averaging, and an option for married joint filing with substantial but less than full income splitting. The flat tax achieves both averaging and full income splitting automatically, but it does so only at the cost of abandoning the progressivity of MTRs and a sharp reduction in vertical equity. The dual tax retains, albeit in moderated form, the same problems as the existing progressive tax rate structure.

Tax registered savings plans

For registered savings plans, the Model tax plan would follow the Alliance plan in abolishing the foreign content limit, but it would do so at once rather than over a five-year period. There is no reason to delay this change as it yields immediate benefits to savers and has no revenue cost. The Model tax plan would not follow the flat or dual tax in raising the allowable contributions to 30 percent of an individual's earnings. This change will benefit only high-income taxpayers (contrary to the Alliance claims), and it is unnecessary to support adequate lifetime savings for retirement needs given the flexible contribution carry-over provisions. The Model tax plan also would not raise the contribution limit for exist-

ing tax-deferred schemes from $13,500, unlike the Alliance proposal to raise this to $16,500. Instead, it would institute a new type of tax-recognized savings plan that operates on a tax-prepayment rather than tax-deferral basis. Contributions to tax-prepaid savings plans (TPSPs) would not be tax deductible, but investment returns within plans and withdrawals would be entirely tax free. The total limit on contributions to both types of plans combined would be raised to $30,000 (of which at most $13,500 could go to tax-deferred plans), all within the 18 percent of earnings limit.

TPSPs offer several important advantages over the existing tax-deferred schemes.[127] First, they entail no immediate revenue cost because the contributions are not tax deductible; relative to tax-deferred plans, the foregone revenues arise only in the future over a long period of time. For this reason, it might be politically feasible to contemplate much larger increases in the dollar limits for contributions to TPSPs than for existing plans. This would place workers at much higher earnings levels on the same consumption-based tax treatment as is now available to low and middle earners. Moreover, TPSPs would be attractive to many low and moderate earners who find saving in tax-deferred plans unrewarding, as they would face much higher effective MTRs when they withdrew funds in retirement than in their working years. The reason for this situation is that many seniors face not only personal income tax rates but also high clawback rates from the Guaranteed Income Supplement and matching provincial income support schemes. With tax-deferred schemes, both the accumulated investment returns and the principal amount withdrawn during retirement face these very high total effective MTRs. With the TPSP, none of the amounts withdrawn bear tax since they had all tax "prepaid" at the time of the initial saving. Hence, TPSPs would expand the incentives for saving at both lower- and upper-income levels. Canadian TPSPs would mirror the Roth IRA plans initiated in the US in 1998, and the enlarged contribution limits would make Canadian taxes more competitive with US taxes for higher earners.

Capital gains

The Model tax plan would reduce the tax inclusion rate for capital gains to one-half.[128] A one-half inclusion rate would restore the Canadian practice from 1972 to 1987, before the 1988 tax reforms. If top combined MTRs were below 45 percent, including half of capital gains would produce a maximum effective tax rate of 22 percent. This rate is just above the top MTR of 20 percent on long-term gains in the US federal tax; it is below the top MTRs on long-term gains in most states. Gains on assets held less than one year would continue to enjoy the preferred rate in Canada, unlike the far higher tax rates on short-term gains in

the US. Again, this change is consistent with economic evidence that efficiency and growth will be maximized by cutting tax rates on savings and capital incomes more than on labour incomes. This change would also result in a lower effective tax rate on capital gains than under the original Alliance flat tax plan, which proposed no change in the tax inclusion rate (then at three-quarters) for capital gains.[129]

The Alliance plan was subsequently revised to include a cut to a one-half inclusion rate for capital gains.[130] The flat 17 percent federal rate along with a typical top provincial rate of about 18 percent would yield a 35 percent total MTR and, with the revised Alliance plan, a 17.5 percent rate for capital gains. This is below the US federal-only rate on long-term capital gains and less than half the US rate on short-term gains. Under the dual tax, the typical top total MTR would be about 43 percent, yielding a top tax rate of 21.5 percent for capital gains, which is quite competitive with the US. The Model tax plan would offer almost as much relief for capital gains, with an effective tax rate just 2 percentage points higher, and its new income-averaging provisions would assist many middle-income earners who obtain capital gains only in occasional years.

The Model tax plan would complement the capital gains tax cut with the abolition or rollover to RRSPs of the lifetime tax exemption on capital gains from small business and farm assets.[131] This provision is often exploited by owners and employees of large Canadian-controlled private corporations. In general, tax policy should avoid complex and horizontally inequitable provisions such as the lifetime tax exemption. The Model tax plan would also adjust the dividend tax credit to keep the effective tax rates on dividends and capital gains synchronized, thereby forestalling manoeuvres such as corporate "surplus stripping."[132] It would further limit interest expense deductions to taxable capital income in any year with a carry-over provision, partly to prevent revenue leakage through leveraged investments and the new lower tax rate on capital gains. These changes would promote horizontal equity, undercut tax avoidance, reduce the revenue cost, and mute the decline in vertical equity. The flat and dual tax plans, in contrast, do not include any such base-broadening or protective measures.

Other changes to the tax base

The Model tax plan would convert three existing non-refundable credits into deductible items: medical expenses and employee premiums for Employment Insurance and the Canada Pension Plan. The 1988 tax reforms converted these items from deductions into credits at the bottom-bracket tax rate. This change was likely undertaken for revenue reasons, but it was mistakenly justified on the grounds of vertical equity.[133] This move confuses the vertical and

horizontal dimensions of equity. As these expenses represent a reduction in ability to pay taxes, they should be granted deduction status. Also, the benefits from the EI and CPP programs are fully taxable, so that the premiums charged for them should be deductible as a form of income averaging. Note that the flat tax does not propose any comparable change, which is understandable in that a deduction is fully equivalent to a non-refundable credit with a flat rate of tax. The dual tax faces this problem but does not propose any remedy.

Finally, the Model tax plan would broaden the personal tax base in several ways. The aim here is not to generate additional revenue but rather to improve horizontal equity across taxpayers. Additional taxes obtained from particular income classes should be returned to them via larger cuts in their MTRs. The following items should be included in taxable income: workers' compensation benefits, social assistance benefits, employer-paid health care benefits, and strike pay.[134] There is no valid reason for taxing other transfer payments, such as EI benefits, but excluding workers' compensation or welfare benefits.[135] This change may necessitate adjustments to benefit rates, but for full-year welfare beneficiaries with no other income, the proposed tax credit levels would still leave them tax free. The current exclusion of employer-paid health benefits is unfair to workers who do not receive them and are paid in fully taxable wages and salaries. The omission of strike pay is also inequitable so long as the union dues which finance those receipts are tax deductible. Two additional tax base changes would eliminate the credits for pension income and Labour Sponsored Venture Capital Corporations. The Alliance tax plan misses an important opportunity to broaden the tax base, being more a tax-cutting than a tax-reforming exercise.

Findings and Recommendations

Many features of the Alliance's tax package are already widely accepted, and indeed most of those changes were recognized as desirable prior to the Alliance proposal. Among those features are the need for cuts to the federal general rate of corporate income tax; cuts to the EI premium rates for employees from the current $2.40 to $2.00 or lower; relaxation or elimination of the foreign content limit on registered savings plans; increased access to registered savings for higher earners; reduced taxation of capital gains; reducing the effective total MTRs for low- and moderate-income recipients of Child Tax Benefits; recognizing the existence of dependent children in higher-income families; raising the taxable thresholds at least to undo the effects of a non-indexed tax system; raising the thresholds of the existing federal tax brackets; cutting the middle-bracket tax rate;

phasing out the high-income surtax; and restoring full indexation to the personal income tax and Child Tax Benefits. Almost all the features cited above were supported in two 1999 reports of the Commons Finance Committee,[136] and most were also included in the actions and five-year commitments made in the 2000 federal budget. A Progressive Conservative Party Tax Task Force in 2000 recommended a package of cuts and reforms containing most of the same items as well as joint family taxation.[137]

Table 17 compares the features of the tax packages of the Liberal and Conservative parties along with that of the Canadian Alliance and the "Model" tax plan put forward in this study. Relative to the Alliance and Liberal programs, the Conservatives would go much further in increasing access to tax registered savings and in cutting capital gains taxes (which they would eliminate). The Conservatives' package also focuses more of its total tax relief on taxpayers at the lowest incomes through larger hikes in the personal credits and a cut in the bottom-bracket rate to 15 percent. Overall, the level of consensus that has emerged among these three national parties on almost all the major directions for tax policy is quite striking. Yet, they all depart from the Model tax plan in their relatively low urgency on corporate and EI cuts; their failure to present a comprehensive policy for reducing the taxation of capital income (no changes to the dividend tax credit or deductibility of interest expense, and small delayed increases in access to tax-deferred plans rather much bolder change through tax-prepaid savings plans); and their refusal to grasp the opportunity presented by tax cuts to broaden the personal tax base for improved horizontal equity. Note that the New Democratic Party is not included in this consensus or the table, as its tax policy prescriptions are diametrically opposed to moves such as lowering upper MTRs, increasing access to registered savings plans, and reducing tax rates on capital gains.

Vertical and horizontal equity

The one key distinguishing feature of the flat tax plan that has *not* been widely or officially accepted is its collapsing of the existing progressive MTR structure into a single tax rate. As has been shown in the present analysis, there are many reasons to reject this element of the original Alliance tax package — an element that is still the party's stated goal. Yet, without this element, the Alliance tax plan comes very close to consensus views on the requisites for improved tax policy in Canada, aside from differences of view over the scale and speed of tax cuts. Adopting a flat rate schedule would sharply reduce the progressivity and vertical equity of the Canadian personal tax system. It would also produce a major shift of the total tax burden away from individuals at very low and at very high incomes and onto the middle-income group. Even though all middle-

income taxpayers would enjoy some tax cuts, these would be proportionately smaller than for those at both tails of the income scale. If a tax cut of the same total magnitude as proposed by the Canadian Alliance were made simply by cutting all the existing tax rates proportionately, with no other changes to the system, the middle class would gain much more than under the flat tax. The Alliance flat tax delivers, relatively, the lion's share of total tax savings to a small group of very high-income taxpayers. If this dramatic dilution in progressivity could be justified on the basis of greatly improved economic performance, which would benefit people at all income levels, then it might be an acceptable policy for society as a whole.

In fact, the sharp cut in progressivity of an Alliance-style flat tax cannot be supported by any of the main criteria used for assessing a good tax system — equity, efficiency or simplicity. There are alternative tax reforms that could achieve much more in terms of horizontal equity, efficiency and growth, and even simplicity than could a flat tax, and they can do so without the severe sacrifice of vertical equity. First consider the criterion of horizontal equity. The Alliance's primary justification for the single rate feature of its tax plan was its desire for equity in taxing one- versus two-earner couples; this was also a main argument in Alberta's 2000 budget announcing the start of a flat rate provincial tax next year.[18] Yet, the income measure used to assess horizontal equity is ambiguous when comparing these types of households, as one-earner units have more time for home production of goods and services. Even if one accepts this view of horizontal equity, it can be achieved equally well with a system of joint filing or income splitting (as in the US income tax) without fully discarding the progressivity of MTRs.

The Alliance flat (and dual) tax, along with the tax proposals put forward by the other parties, are also deficient in other aspects of horizontal equity. Most previous flat tax proposals have used the opportunity posed by major tax cuts and structural change to broaden the base for more comprehensive coverage. Items that had been excluded from the tax base for historical or political reasons should be included in taxable income if they affect the relative resources and well-being of various taxpayers. Some examples have been cited — workers' compensation and social assistance benefits, employer-paid health care benefits, strike pay, and credits for old age, pension income, and investments in Labour Sponsored Venture Capital Corporations. By failing to tackle such items, the flat tax and other tax proposals miss an opportunity to correct tax inequities between workers with and without employer-paid health benefits, unionized and non-union workers, aged and non-aged taxpayers, and low-wage workers and households dependent on transfer benefits. Taken together, these inequities are more substantial than those present in the current tax treatment of single versus dual-earner couples.

Table 17
Comparison of Tax Reduction Plans of Three Political Parties and Model Tax Plan[a]

a. Consensus Proposals

Item	Recommendation
Basic personal credit	Increase the amount *Model tax plan*: at least $9,000 *Alliance*: $10,000 *Conservatives*: $12,000 *Liberals*: at least $8,000
Spousal/Equivalent-to-spouse credit	Increase the amount *Model tax plan*: at least $7,500 *Alliance*: $10,000 *Conservatives*: $12,000 *Liberals*: at least $6,800
Bottom bracket upper limit	Widen the bracket *Model tax plan*: widen to $40,000 *Alliance*: flat tax would extend it to all taxable income; dual tax would widen to $100,000 over 5 years *Conservatives*: widen to $40,000 *Liberals*: widen to at least $35,000
Middle bracket rate	Reduce the rate *Model tax plan*: reduce to 23% *Alliance*: reduce in steps to 17% over 5 years, after which there is no middle bracket in flat or dual tax plan *Conservatives*: reduce to 24% *Liberals*: reduce to 23% within 5 years
Top bracket threshold	Raise the threshold *Model tax plan*: raise to $120,000 *Alliance*: with dual tax, raise to $100,000 *Conservatives*: raise to $90,000 *Liberals*: raise to at least $70,000
High income surtax	Eliminate *Model tax plan*: eliminate immediately *Alliance*: eliminate immediately *Conservative*: eliminate immediately *Liberals*: raise threshold for 2000, lower the rate in 2001, eliminate it by 2004

a. Consensus Proposals (continued)

Item	Recommendation
Capital gains inclusion rate	Reduce the rate *Model tax plan*: reduce from 66.7% to 50% *Alliance*: reduce from 66.7% to 50% *Conservatives*: reduce from 66.7% to 50%; later revised to reduce to 0% *Liberals*: reduced from 75% to 66.7% in 2000 budget
General corporate tax rate	Reduce the rate *Model tax plan*: reduce quickly from 28% to 21% and lower *Alliance*: reduce to 21% over 5 years *Conservatives*: reduce combined federal-provincial rate to 35% over 5 years *Liberals*: reduce to 21% within 5 years
Employment Insurance premium rates	Reduce the rates *Model tax plan*: reduce rates quickly to levels that sustain program benefits *Alliance*: reduce employee rate to $2.00, per $100 of earnings, phased over 5 years *Conservatives*: "reduce and eventually eliminate profit insensitive payroll and capital taxes" *Liberals*: same as Alliance plan, phased over 5 years

b. Dissenting Proposals

Item	Recommendation
Creation of a new child deduction	*Alliance*: $3,000 per child *Conservatives*: $2,353 per child
Child Tax Benefit	*Model tax plan*: convert to universal benefit for above-median incomes, and reduce phase-out rates for lower incomes *Liberals*: further enrichments, extending to somewhat higher incomes
Bottom rate bracket	*Conservatives*: reduce to 15%
Top rate bracket	*Alliance*: under dual tax, reduce to 25% *Conservatives*: reduce to 27%

b. Dissenting Proposals (continued)

Item	Recommendation
Income splitting	*Model tax plan*: introduce married joint filing schedule with substantial income splitting *Conservatives*: option of filing as family unit with full income splitting
RPP & RRSP foreign content limit	*Model tax plan*: eliminate entirely *Alliance*: eliminate over 5 years *Conservatives*: raise to 50% *Liberals*: raise to 25% for 2000 and 30% for 2001 (in 2000 budget)
RPP & RRSP contribution percentage limit	*Alliance*: raise to 30% of earned income, from the current 18%, over 5 years
RPP & RRSP contribution dollar limit	*Model tax plan*: no increase but introduce generous tax-prepaid savings plans *Alliance*: raise to $16,500 over 5 years *Conservatives*: raise to $20,000 from current $13,500 over 4 years *Liberals*: raise RPP ceiling to $14,500 in 2003, $15,500 in 2004; raise RRSP ceiling to $14,500 in 2004, $15,500 in 2005[b]
Small business corporate tax rate	*Alliance*: reduce rate to 10% over 5 years; reduce to 21% on $200,000 to $300,000 incomes in 2001 *Liberals*: reduce rate to 21% on $200,000 to $3000 incomes in 2001 (in 200 budget)
Other tax changes	*Alliance*: disallow first $3,000 of claims for child care expense deduction (offset by new child deduction of $3,000) *Conservatives*: defer tax on employee stock options until shares are sold; eliminate capital gains tax on gifts of listed securities; raise threshold for alternative minimum tax to $90,000 *Liberals*: defer tax on employee stock options until shares are sold; allow tax-free rollovers of capital gains for small-business investors (in 2000 budget)

c. Proposals Specific to Model Tax Plan

Item	Recommendation
Personal credits	Eliminate age credit
Tax rates	Reduce or eliminate provincial high-income surtaxes Introduce liberal income-averaging provisions
Registered savings	Introduce new tax-prepaid savings plans with much higher contribution limits (up to $30,000)
Capital gains	Adjust dividend tax credit for balance with lower inclusion rate for capital gains Eliminate lifetime capital gains exemption for small business and farm assets; possibly replace with RRSP rollovers Limit interest deductions to taxable investment incomes with carryovers
Medical expenses	Convert from a credit to a deduction
Employee premiums for EI & CPP	Convert from credits to deductions
Broaden tax base	Add workers' compensation benefits Add social assistance benefits Add employer-paid health care benefits Add strike pay Eliminate pension income credit Eliminate Labour-Sponsored Venture Capital Corporation credits
General corporate Income tax	Introduce corporate distribution tax

[a] Note that this summary does not include any of the tax changes included in the government's October 2000 mini-budget, which are discussed in an addendum to this study. See note 137 to text regarding subsquent changes to the Conservatives tax plans. All plans would fully index all key tax parameters for inflation, as was implemented in the 2000 budget.
[b] This account is based on the last official pronouncement on the topic, in the 1996 federal budget.

Sources: Canadian Alliance Party, "Tax Reduction *and* Tax Reform" (January 2000); Dale Orr and Bob Dugan, "Economic and Fiscal Impact of Canadian Alliance Proposals for Tax Reduction: Update," Ottawa, WEFA Inc. (September 2000), mimeo; Canada Department of Finance, *Budget 2000 — Budget Plan*, Ottawa, February 28, 2000; Progressive Conservative Party of Canada, *Task Force on Taxation, Report of the Task Force: Creating a Culture of Opportunity*, Ottawa (February 2000); Joe Clark, "We'd Kill the Capital Gains Tax," *Financial Post*, September 28, 2000, p. C19.

The only way that the Alliance flat tax plan can make any plausible claim to "progressivity" is through its large increases to the basic, spousal, and spousal-equivalent exemptions and its new deduction for dependent children. As the promotional material for the plan states, these changes will remove 1.4 million low-income Canadians from the federal income tax rolls. This claim for the flat tax is incontestable, but it is entirely due to the plan's large increase in exemption levels and has nothing to do with the flat tax rate. Exemption levels could be increased within the existing system of progressive MTRs, and there is no necessary or logical connection between this change and the introduction of a single tax rate. Indeed, the proposed flattening of the tax rate schedule, which would apply only to the federal rate brackets above 17 percent, would produce no gains for the poor.[19] In fact, reducing all federal MTRs to 17 percent would yield no benefit for 78 percent of all Canadian individuals or for the 56 percent of all taxpayers who already face a 17 percent rate (see Table 8).

The flat tax's large increase in the taxable thresholds may divert attention from the massive tax savings that would be generated for very high-income households through the single tax rate. These gains to top earners would be only partially attenuated by the transitional shift to a dual tax scheme, with a top federal rate of 25 percent applying to incomes over $100,000. The dual tax brings the Alliance proposal closer to the mainstream of Canadian tax policy, including that of all the other national parties, which retain progressivity of MTRs. Still, the differences between the flat and dual tax plans should not be exaggerated. If either policy were fully implemented in 2000, the estimated difference in federal revenues would be just about $2.4 billion or only three percent of current revenues from the personal tax. This reflects the relatively few taxpayers who would be affected by the higher dual rate. Moreover, the dual tax reduces the MTR to the basic 17 percent rate for all taxpayers between $30,000 and $100,000 of annual income. This raises the equity question of whether individuals at middle and upper-middle incomes (up to $100,000) should pay tax at the same marginal rate as those at very low and moderate incomes ($10,000 to $30,000).

Economic efficiency and growth

The flat tax plan also falls short with respect to improving economic efficiency and growth. It assumes that a single tax rate, much reduced from the rates currently imposed on middle and particularly high earners, will be the optimal way to improve incentives for economic performance. However, this approach is contrary to the evidence presented by a large body of theoretical and empirical economic analyses, which show that there is a more pressing need to cut tax rates on savings and capital incomes than on consumption and

labour incomes. This goal can be achieved best within the personal tax by shifting its base further toward consumption and away from capital incomes for those at higher incomes. The Canadian personal "income" tax is already close to a consumption-based tax for the lower 95 percent of taxpayers by virtue of tax provisions for registered savings plans and the exemption of capital gains on homes. At upper-middle incomes, another priority is for a significant cut in MTRs, especially for a large range of incomes above the current $60,000 threshold for the top federal tax rate (aside from surtax). The flat tax addresses this issue with a relatively blunt instrument — a single rate for all taxpayers — which cuts tax rates more than needed at upper-middle incomes and much more than economically justified at the highest incomes. It is notable that the shift to a dual tax was not combined with any further moves to reduce the effective tax burden on savings and capital incomes.

To maximize the economic benefits of tax cuts at upper incomes, the cuts in rates should be moderated in exchange for increasing the access to registered savings plans, further cuts to capital gains taxes, and faster and sharper corporate income tax rate cuts. Instead of simply raising the dollar limits for contributions to existing registered savings plans, a more revenue-effective and equitable approach would be to institute tax-prepaid savings plans (TPSPs). Unlike existing tax-deferred plans, these new plans (patterned after Roth IRA plans in the US and Individual Savings Accounts in the UK) would provide no tax deductions for allowable contributions, but all accruals in and withdrawals from the plans would be tax free. Reducing the tax inclusion rate for capital gains to one-half would restore the practice in Canada from 1972 to 1987 and make Canadian tax rates fully competitive with comparable US rates. And cutting the corporate income tax rate quickly from 28 percent to 21 percent, followed by further rate cuts to undercut US corporate tax rates, would offer a potent stimulus to growth of investment, productivity, real wages, and employment in Canada.

Given the current state of the Canadian economy that is approaching full productive capacity and full employment, there are grounds for giving greater priority to these supply-enhancing tax cuts rather than large cuts in basic personal tax rates or exemption levels that would boost consumer demand. The latter parts of the tax-reduction package could be phased in when the economy slows or enters the next recession. In contrast, the Alliance tax plan would inject large stimulus to consumer demand over the next five years, which could press against the economy's productive capacity. By stimulating the aggregate supply of real output and dampening inflation through productivity increases, more supply-oriented tax cuts and reforms would extend the business expansion and lift the economy's long-run growth rate. An optimal tax package for Canada will

focus at the outset on augmenting incentives for savings, investment, and entrepreneurial activity in preference to consumer spending.

Competitive personal income tax schedule

The suggested changes to the personal tax base would bring the Canadian system closer to the US system, which offers far more generous access to tax-recognized savings and lower rates of tax on long-term capital gains. In contrast, the Alliance flat tax would create marginal tax rates in Canada that were much below those in the US at high incomes. Combining a 17 percent federal tax rate with a typical provincial top MTR of about 18 percent yields a total MTR well below the top US MTR at the federal level alone (and this applies only for the few states without their own income taxes). If the Alliance flat tax at the federal level were combined with the forthcoming Alberta flat tax of 10.5 percent, this produces a total flat MTR of just 27.5 percent.[14] This rate falls below even the US federal-only rate for incomes above just US$26,250 (single filers) and US$43,850 (married joint filers). These tax changes, taken together, would go beyond what is needed for a tax system to be competitive with US rates at middle and higher incomes. The dual tax would have a top federal MTR of 25 percent that would yield a total top MTR in a typical province of less than 45 percent; in Alberta, the top total MTR would be just 35.5 percent.

A suitable goal for combined federal-provincial tax rates is to get the top MTRs into the lower 40 percent range — no more than 45 percent — striking only incomes above $120,000. For at least 98 percent of taxfilers, it would be desirable to impose a total MTR of no more than 35 percent (excluding benefit clawbacks). And for the majority of taxfilers, in the bottom federal tax bracket, it would be desirable to impose a total MTR of no more than about 25 percent (excluding benefit clawbacks). All of these goals should be closely approached in both Alberta and Saskatchewan over the next one to three years, with the phase-out of the federal high-income surtax and cuts to the provincial tax rates. Clearly, other provinces could follow this path if they so desired. This approach leaves a great deal of revenue room for shifting the personal tax base further toward consumption at higher incomes. If the suggested base-broadening measures were adopted, even lower rates of tax could be applied at low and middle incomes.

The Alliance dual tax plan would achieve the suggested goals for MTRs at various income levels, but it would do so through a combination of lower federal rates and higher provincial rates than might be desirable. Of course, a national tax policy cannot do anything more than counsel the provinces about how they should manage their own tax policies. But there are pressures for the provinces to reduce the progressivity of their personal tax systems, and indeed provinces such as Alberta and Saskatchewan are moving strongly this way, with others such as British Columbia,

Ontario, and Quebec following more gingerly. The empirical evidence from the US is that lower jurisdictions only harm themselves in terms of economic growth and attracting high-paying jobs by pursuing much tax progressivity. Hence, the main responsibility for maintaining substantial progressivity must lie with the federal government. The dual tax plan has a 25 percent top federal rate, which combines with a typical top provincial rate of about 18 percent to yield an acceptable total top MTR of 43 percent. If the provinces further flatten their personal tax rate structures, the overall vertical equity of the system will be compromised, which will threaten even the current mild progressivity of the overall Canadian tax system. It would thus be wise to maintain a higher top federal MTR, such as the current 29 percent, even though its income threshold should be sharply raised.

Simplicity

On the final criterion for good tax policies — simplicity — the Alliance tax plans (and those of the other parties) again do not score highly despite the initial appearances. The tax base is a far more complicating aspect of the personal tax than the rate structure. Almost all taxpayers currently compute their actual tax liability using either a computer tax program or the tax tables supplied with the tax forms; this would continue to be the case even with a flat tax rate. If one were to take a professional income tax manual, or a collection of tax interpretation bulletins plus court rulings on tax cases, more than 99 percent of the matters covered would be seen to derive from issues of tax base and measuring taxable income rather than the tax rate structure. Going to a flat tax rate would save at most two or three lines for tax calculation on the tax return plus another line for computing non-refundable tax credits; the dual tax would save even less. More lines are saved by removal of the general surtax and the high-income surtax. And other base-broadening moves such as abolishing the age and pension credits and the lifetime capital gains exemption — items not included in the Alliance's or other parties' policies — would also save more lines from the tax forms and more complexity from tax compliance, planning, auditing, and enforcement than the savings from a flat rate tax schedule.

Political sustainability

In addition to the traditional criteria for assessing taxes, one might consider the political economy aspects of introducing a flat tax. If a flat tax were implemented by Canada, even as a successor to a dual tax, this would place political constraints on any future income tax increases. That property may be intended by proponents of the proposal. Yet, there could emerge future pressures, such as increasing expenditure needs for a mounting group of retirees, that would

demand additional revenues. For distributional reasons, it would be difficult to decrease the basic exemption levels, and raising the single rate of tax might also be resisted because it would affect those at moderate incomes as well as middle and higher incomes. As a result, governments might be constrained to apply a variety of user charges and more distorting types of tax levies to finance their spending needs. These alternative revenue sources might be inferior in both equity and efficiency to income tax increases. One might further question the sustainability of a flat tax if implemented. It probably would not survive the change to a government of centrist or left-of-centre persuasion, which would reinstate either multiple rates or some form of surtaxes.

A smarter alternative

It is instructive that all the economic and social benefits sought by the Canadian Alliance (and other parties') tax proposals could be achieved more effectively by an alternative policy with substantial overlap. A preferred policy package would make greater strides toward horizontal equity, efficiency and growth, and tax simplification but with much less sacrifice of vertical equity than is entailed in the Alliance flat tax or even the dual tax. The Model tax plan would move the personal tax base further toward consumption and would pursue more ambitious cuts to corporate income tax rates than do the plans of the Alliance or any other party. It would also reduce marginal tax rates significantly at moderate and upper-middle incomes, but less so at middle incomes and much less at top incomes. In assessing the reasons cited by the Alliance for choosing a single rate for the personal tax, each was found to be either misconceived or less optimal than an alternative tax strategy that could achieve the same goals without abandoning vertical equity. This point may have been implicitly acknowledged by the transitional shift to a dual rate scheme, although the lack of any improvements in the remaining tax provisions does not confirm this. It is essential to target tax cuts on the bases and income ranges that will yield the greatest economic benefits relative to the revenues foregone. A Model tax plan will involve tax reform as much as tax cuts; it will rely on taxes that are smarter and lower and even a bit flatter without going all the way to a single rate or even as far as a dual rate tax.

Addendum: Mini-Budget Tax Changes

Less than two weeks after the Alliance's release of its electoral platform, stating its interim goal of a dual rate tax, the federal government offered its own major tax changes in a regular fall economic and budget update.[41] This "mini-budget" con-

tained unusually pointed and critical references to the Alliance flat and dual tax plans.[142] In addition to the $58 billion of planned tax cuts over five years that had been announced in the 2000 budget, the mini-budget offered an additional $42 billion in tax cuts.[143] This figure represents a substantial portion of the Alliance pledge to cut taxes by $66 billion, also over five years and in addition to the budget figure.[144] The federal government also offered a debt reduction figure for 2000–01 that was roughly on par with that of the Alliance plan, but unlike the Alliance plan, it did not commit to specific figures for large ongoing debt repayments in future years. This difference could be explained by the existing government's plans for larger program spending in future years, which it stated would grow less rapidly than the economy. Given that the Canadian economy was projected to grow by an average nominal rate exceeding 5 percent, this still allows the government to undertake much faster federal spending growth than the 2.5 percent rate targeted by the Alliance.

The personal tax rate cuts in the mini-budget are particularly notable. As of 2001, the bottom-bracket rate, which is applied to about the first $31,000 of taxable income, will be reduced from 17 to 16 percent; the mid-bracket rate for incomes between about $31,000 and $62,000 will be reduced to 22 percent from the 26 percent pre-budget 2000 and 24 percent as of mid-2000; a new tax bracket with a rate of 26 percent will be introduced for incomes from $62,000 to $100,000; and the current top-bracket rate of 29 percent will continue to apply, but only for incomes above $100,000 rather than the current $60,009 level. In addition, the high-income surtax will be fully eliminated rather than being phased out over a period of years as stated in the February 2000 budget. The mini-budget does not raise the income thresholds for the second or the new rate bracket beyond the inflation rate. The rate cut for the second bracket and the new 26 percent bracket for incomes below $100,000 should help significantly to improve the competitiveness of the Canadian tax system for many knowledge workers. This also addresses part of the competitive shortcomings of the Canadian personal tax rate structure vis-à-vis that of the US, as can be seen in the earlier Figures 1 to 3. In line with this study's analysis, retaining a top federal rate of 29 percent is well justified based on comparisons with US taxing jurisdictions as well as the greater economic urgency of reducing the tax burden on savings and capital incomes at higher income levels. A goal for the longer run, however, should be to raise the point at which the top rate applies to at least $120,000.

The personal tax cuts in the mini-budget were designed to exceed those in the first year of the Alliance dual tax plan for almost all taxpayers, despite the fact that the total Alliance tax cuts for individual taxpayers cumulate to a larger sum over the five-year period. This situation can be explained by the planned

implementation schedule for the Alliance tax plan as shown in Table 15. Under the Alliance scheme, bottom-bracket taxpayers would remain at 17 percent in 2001 (versus 16 percent in the government plan); those with incomes from about $31,000 to $62,000 would be taxed at 23 percent (versus 22 percent); those with incomes from $62,000 to $100,000 (as well as those above $100,000) would be taxed at 28 percent (versus 26 percent for those up to $100,000 and 29 percent for those above $100,000). Hence, only a small number of taxpayers at extremely high incomes, and some at very low incomes, might find their tax burdens lower in 2001 under the Alliance plan than with the government plan. Once fully implemented, though, the dual tax plan would provide larger tax cuts to all income groups than would the government plan (assuming no further cuts in future years). This is true even for all the lowest earners, because the Alliance's hikes in basic and spousal credits and its proposed new child deduction are worth more than the government's 1 percentage point cut in the bottom-bracket rate. The latter cut is worth little to taxpayers just above the taxable threshold and at most about $230 per year for those with incomes near the top of the tax bracket.

The bottom-bracket rate cut to 16 percent can be seen as an attempt by the government to undercut the Alliance's 17 percent flat rate, at least for low and moderate earners. It is questionable whether this is good economic policy as distinct from political strategy. The mini-budget does not raise the credits for filer or spouse for 2001 beyond the indexation amounts, so that income tax will still be applied at very low incomes.[145] A cut of 1 percentage point in the bottom rate will do little to relieve the problems of high total marginal tax rates resulting from the taxbacks of various tax and transfer provisions. In fact, the limited relief offered for persons at very low incomes by the mini-budget is achieved through provisions that will actually raise the effective MTRs over some income ranges.[146] These include an enrichment to the National Child Benefit Supplement on top of that in the 2000 budget. A better alternative than cutting the bottom rate bracket by 1 percentage point would have been to cut EI premiums more sharply. A cut of 50 cents per $100 of earnings for employees would have been feasible in view of the large EI surplus, and it would have yielded an eventual 1.2 percent increase in wages of low to moderate earners after the employer's share of the cut is shifted back to workers. This approach would have given workers, including non-taxable part-time and low-wage workers, greater benefit than the bottom-bracket tax cut, and it would also have increased their employment opportunities.

In terms of tax reform rather than simply rate cuts for personal income taxes, the mini-budget proposals — like those of the Alliance and the Conservatives — offer very little. There is no attempt to broaden the taxable base

to include any significant excluded items or to remove special tax provisions. The mini-budget even adds another special provision in the form of a temporary tax credit for individual investors in flow-through shares for Canadian mining exploration. Items such as medical expenses and employee payroll taxes that should be tax deductible are mostly left as non-refundable tax credits; the cut in the bottom-bracket rate will further depreciate the value of these credits. A small exception is that the self-employed will be allowed to deduct (rather than claim credits for) one-half of their Q/CPP premiums, to parallel the tax deductibility of employer premiums. And the mini-budget offers no provisions for income tax averaging by individuals whose earnings vary substantially from year to year. With the new tax bracket, more individuals will be shifted across brackets because of year-to-year variations and thus will suffer the horizontal inequities and a deterrence to entering riskier occupations and business endeavours.[147] A flat tax or even the dual tax would reduce this problem considerably for the great majority of taxpayers. The government's changes also do not mitigate the large relative differential in federal taxes for one- versus two-earner families, though they do reduce the dollar differences. Real advances on this front, if desired, would require adopting some form of joint filing or else the flat or dual tax plan.

A major theme of this study's analysis is the relative importance of reducing the tax rate on savings and capital incomes, particularly at higher-income levels, vis-à-vis simply cutting the top MTR. The mini-budget's cut in the tax inclusion rate for capital gains to 50 percent conforms with this study's recommendations and those of the Alliance.[148] The Conservatives would go further by eliminating the tax on capital gains; this would revisit the kinds of tax avoidance, complexities, and inequities that arose in Canada prior to the application of tax on gains in 1972. It would also provide massive windfalls for current holders of appreciated assets, much of which have been held for many years — if not generations — with little incentive for incremental saving or investment. Given the two cuts in the capital gains tax inclusion rate in a single year, there will likely be pressures from business, financial, and investor groups for still further cuts. Yet the rate applied after the mini-budget leaves Canada with top total tax rates on gains from assets sold after one year somewhat below the rates applied in typical US jurisdictions. For assets sold within one year of purchase, the Canadian top tax rates on such gains are just one-half those of US counterparts.

A much better approach than any further cuts to capital gains tax rates would be to pursue aggressive increases in the accessibility to registered savings for both moderate- and high-income individuals. Registered savings plans in effect apply a zero tax rate to all capital income, including capital gains; yet they do so in a way that is limited to lifetime savings for retirement and does not pro-

vide massive windfalls to wealth holders. Our analysis has cited reasons to prefer introducing tax-prepaid savings plans rather than raising the limits for contributions to existing tax-deferred plans. But the mini-budget has done neither, nor has it offered any goals for future changes in this area. This contrasts with the modest increases in the Alliance tax plan, the larger increases in the Conservative plan, and the much larger hikes in the Model tax plan. Apparently the political pressure facing the government was to devote as much as possible of the funds for tax cuts in 2001 to highly visible cuts in personal tax rates. This could also explain why there was no enrichment of the dividend tax credit, even though there will be a growing imbalance in tax rates on dividends and capital gains.

Political considerations could further explain why the mini-budget's cut in the corporate tax rate for 2001 is no larger than the 1 percentage point already committed in the 2000 budget (and in the Alliance plan). While the faster, more definitive cuts in the general corporate rate to 21 percent by 2004 are positive moves (and just match the Alliance timetable), in Alberta and Ontario the planned cuts to total corporate tax rates result from provincial moves as much as federal actions.[14] Ontario, Quebec, and British Columbia could be facing similar competitive pressures to flatten their personal tax rate schedules and cut their top tax rates, following the lead of Saskatchewan and particularly Alberta, as well as most US states. If that occurs in future years, maintaining even a modest degree of progressivity in Canada's overall tax system may even dictate *raising* the top federal MTR on the highest incomes. Concomitant shifts toward a "smarter," more efficient tax base would preserve the gains from improved economic performance. That result would also mirror the pattern in the US of low and relatively flat taxes at the lower jurisdictional level and higher top MTRs for upper incomes at the federal level. Taxation policy cannot neglect any of its multiple goals — vertical equity as well as horizontal equity, simplicity, and efficiency and growth.

Notes

1 Of the 2000 federal budget's total personal income tax cuts (excluding Child Tax Benefit changes) pledged for 2004–05, more than half were simply the result of restoring full indexation and hence are a result of not raising further the real bite of taxes.

2 It will be left to political observers to divine whether the switch to the dual rate tax "in our first term in office" as a "move towards a single rate of tax" is merely strategic or a graceful attempt to abandon the earlier plan. See Canadian Alliance, *A Time for Change: An Agenda of Respect for All Canadians*, October 5, 2000, p. 10.

3 Monte Solberg, "The Alliance's Solution 17," *Policy Options*, Vol. 21, no. 8 (October 2000), pp. 7-9.

4 See the Canadian Alliance website at *www.canadianalliance.ca/solution17*. All materials were taken from this website as of October 1, 2000.

5 The Alliance scheme is commonly called the "flat tax" plan by the media, and this label is convenient for brevity. An earlier Canadian flat tax proposal would also have retained many existing provisions such as credits for RRSPs and charitable contributions. See Dennis Mills, *The Single Tax: Fair and Simple for All Canadians* (Toronto: Hemlock Press, 1990). Note that a flat tax can be either income-based or consumption-based; the Alliance flat tax is the former. For design issues and economic analysis of both flat and dual taxes, see Jonathan R. Kesselman, *Rate Structure and Personal Taxation: Flat Rate or Dual Rate?* (Wellington, NZ: Victoria University Press for the Institute of Policy Studies, 1990). For additional economic analysis of flat taxes, both in general and in a Canadian context, see G.C. Ruggeri and Carole Vincent, *An Economic Analysis of Income Tax Reforms* (Aldershot, UK: Ashgate Publishing, 1998).

6 The "fair tax plan" is described as "meaningful tax relief by moving towards a single 17% rate for everyone" (Canadian Alliance, *A Time for Change*, p. 9). Party leader Stockwell Day stated, "We're still on the program: a single rate of tax for everybody is still on. It's going to take some people five years to get there instead of four." *Vancouver Sun*, October 7, 2000, p. A6.

7 For example, one common fallacy has been to compare the top rates for Canadian federal plus provincial taxes with US federal taxes alone (also ignoring a portion of US payroll taxes that apply to the highest earnings). See Stanley Taube and Michael Taube, "Canadian Alliance's flat tax proposal will benefit all Canadians," *Globe and Mail Report on Business*, August 24, 2000, p. B10.

8 The alternative Model tax policy developed here derives primarily from Jonathan R. Kesselman, "Base Reforms and Rate Cuts for a Revitalized Personal Tax," *Canadian Tax Journal*, Vol. 47, no. 2 (1999), pp. 210–41.

9 For an analysis of the relation between Canadian tax policy and both productivity and brain drain, see Jonathan R. Kesselman, "Policies To Stem the Brain Drain — Without Americanizing Canada," Vancouver, UBC Department of Economics (February 2000), mimeo.

10 A *marginal* tax rate is the incremental tax that is applied to an extra dollar of income at a particular income level; it is commonly distinguished from the average tax rate, which is simply an individual's tax liability divided by their income.

11 Sources for these figures are: Canada, Department of Finance, *Fiscal Reference Tables, September 2000*, Cat. no. F1-26/2000E (Ottawa: 2000), Tables 33, 36, 39, 42; US Bureau of Economic Analysis, *Survey of Current Business* (October 2000), National Data: A. Selected NIPA

Tables, Tables 3.1, 3.2, 3.3. Note that these figures include outlays on public debt service as well as program costs.

12 These figures as well as other international figures cited in this section are for 1997 and are taken from the same source as the figures in Table 1.

13 Other comparisons with the tax mixes and policies in OECD countries will be examined later in our assessment of tax strategies that can raise needed revenues at minimal cost to efficiency, investment and productivity.

14 See Statistics Canada, *The Daily*, November 30, 1999. Surprisingly, even major internationally traded goods are often priced lower in Canada than in the US. For example, a base model 2000 Honda Accord has a manufacturer's list price of $22,000 in Canada and US$18,540 in the US, implying a PPP of 84.3 US cents per Canadian dollar.

15 These figures assume all income is labour earnings and consider only the personal exemption or credit in both countries plus the standard deduction in the US and the non-refundable credit for employee payroll taxes in Canada.

16 In our analysis, we designate the combined cash benefits of the Canada Child Tax Benefit and the National Child Benefit Supplement as the CTB.

17 The American EITC has been greatly enriched over the years and is now a US$30.4 billion program. In 1999, it paid maximum annual benefits of US$2,313 for one child and US$3,816 for two children; these benefits are structured as earnings subsidies and thus require labour earnings.

18 Singles in the US are defined for tax purposes as unmarried persons; in the US, unlike in Canada, common-law partners are not treated in the same way as married couples for tax purposes. The head-of-household filing status is reserved for individuals who provide most support for specified classes of blood and adoptive relatives; it is used most frequently by sole parents.

19 See Saskatchewan Personal Income Tax Review Committee, *Final Report and Recommendations* (Regina: November 1999) and Saskatchewan Department of Finance, Taxation and Intergovernmental Affairs Branch, *A Plan for Growth and Opportunity: Personal Tax Reform in Saskatchewan* (Regina: March 29, 2000).

20 For the US, any municipal and county income or payroll taxes are ignored. Also ignored in the tabulated figures are the effects of federal income tax deductibility of state income taxes (see Note d, Table 5).

21 The US taxes gains on assets sold within one year as short-term gains at the taxpayer's full MTR but applies lower tax rates for "long-term" gains on assets held for more than one year. The Canadian tax system does not distinguish between short- and long-term gains, both of which receive preferential tax treatment. Note also that the US federal top tax rate of 20 percent on long-term gains applies to all taxpayers whose other income places them in an ordinary tax bracket of 28 percent or higher, so that it affects many taxpayers at barely middle-income levels as well as higher earners.

22 It is commonly claimed that Canadian tax rates on capital gains are "double" those in the US. Clearly, for short-term capital gains, the rates are much lower in Canada than the US, with or without state/provincial taxes included. For long-term gains, the commonly cited US tax rate of 20 percent refers solely to the federal income tax and ignores the fact that most states also tax capital gains, typically at full rates with no preference. This 20 percent federal rate for the US is often compared with the combined federal-provincial tax rate in Canada.

23 The examples do not consider any deductions beyond the employee payroll

taxes in Canada and the standard deduction in the US and the personal exemptions or credits in both countries.

24 The analysis also ignores two complications in the US federal tax that have largely offsetting effects — deductibility of state income taxes in the federal tax, subject to limitations (which can reduce the effective MTR by about two to three percentage points); and phase-out of personal exemptions at higher income (which can increase the effective MTR by 2.24 percentage points times the number of individuals claimed on the return).

25 This is the so-called "marriage penalty" which arises when the spouses' incomes are nearly equal.

26 There are good reasons not to replicate the American provisions regarding home mortgage interest, property taxes, part of Social Security income, and tax-free state and municipal bond interest. These provisions carry inefficiencies, horizontal inequities, and unwarranted loss of revenues vis-à-vis simply lowering tax rates.

27 Note that the distributional tables prepared by the Alliance ignore any tax savings from the flat tax's increase in contribution limits for registered savings plans.

28 Surprisingly, the tables showing tax savings by income levels in the Alliance analysis and webpages for the flat tax include income ranges only up to $70,001–$80,000. These tables thus conceal some of the largest and most noteworthy distributional impacts of the flat tax. Comparable tables released by the Alliance for its dual tax show income levels up to $300,000.

29 For taxpayers with dependants, this declining pattern would continue up to higher incomes before reversing because of the enlarged exemptions for spouse/equivalent and the proposed new deduction for children.

30 If this increase were implemented alone within the existing federal tax rate structure, it is assumed that these amounts would continue to be fashioned as non-refundable credits rather than deductible amounts.

31 See the Canadian Alliance, "Tax Reduction *and* Tax Reform," January 2000, p. 47; this document can be downloaded from the party's website at *www.canadianalliance.ca/solution17/backgrounder.html*. These figures are all costed relative to the pre-2000-budget situation.

32 Actually, the original figure reported was 1.9 million, but this was later reduced in the Alliance campaign document, *A Time for Change*, p. 9. The figure should be the same for the flat and dual taxes.

33 These results are based on the Statistics Canada Social Policy Simulation Database/Model (SPSD/M). They assume that the existing federal income tax is applied with its parameters for the 2000 tax year and, alternatively, that the flat tax is applied for 2000 with its single tax rate and higher levels of personal credits and the new child deduction.

34 The empirical evidence suggests that taxes paid by and revenues collected from high-income groups on their capital gains would rise for a few years after a cut in capital gains tax rates, but there is controversy over whether this would continue into the longer run. See George R. Zodrow, "Economic Issues in the Taxation of Capital Gains," *Canadian Public Policy*, Vol. 21, Supplement (November 1995), pp. S27–57. The Alliance flat tax is less likely to collect additional taxes on capital gains even in the shorter term, since it contains both a sharp cut in the tax rate at higher incomes and a cut in the tax inclusion rate.

35 This pattern is fairly typical for other flat tax plans; for example, see Roger S. Smith, "Flat Rate Tax Potential: A Preliminary Comparison of Three Countries," *Canadian Tax Journal*, Vol. 34, no. 4 (July-August 1986), pp.

835–52. Smith concludes that "A flattening of rates shifts the tax burden away from higher income groups…Massive shifts in tax burdens will be unacceptable to politicians and the electorate" (pp. 836, 849). Another early quantitative study of flat taxes in Canada was by Michael A. Walker, *On Flat-Rate Tax Proposals*, Focus No. 4 (Vancouver: The Fraser Institute, 1983). It concluded that a flat tax in Canada "would produce a certain amount of perverse redistribution of the tax burden but that the extent of this redistribution is likely to be less than is often imagined" (p. 38).

36 Our later analysis of the fiscal aspects of the Alliance plan tends to confirm this view.

37 Families with incomes between $70,000 and $75,000 bear slightly larger shares; $75,000 to $80,000 slightly smaller shares; $80,000 to $85,000 slightly larger shares; $85,000 to $90,000 slightly smaller shares; and $90,000 to $100,000 slightly larger shares. Also, those from $55,000 to $60,000 bear slightly larger shares.

38 Key Canadian studies are the following: Frank Vermaeten, W. Irwin Gillespie and Arndt Vermaeten, "Tax Incidence in Canada," *Canadian Tax Journal*, Vol. 42, no. 2 (1994), pp. 348–416; G.C. Ruggeri, D. Van Wart and R. Howard, "The Redistributional Impact of Taxation in Canada," *Canadian Tax Journal*, Vol. 42, no. 2 (1994), pp. 417–51; and Arndt Vermaeten, W. Irwin Gillespie and Frank Vermaeten, "Who Paid the Taxes in Canada, 1951–1988?" *Canadian Public Policy*, Vol. 21, no. 3 (September 1995), pp. 317–43. These studies differ in their findings, particularly about the incidence pattern of general sales taxes.

39 See James Davies, France St-Hilaire and John Whalley, "Some Calculations of Lifetime Tax Incidence," *American Economic Review*, Vol. 74, no. 4 (September 1984), pp. 633–49.

40 Martin Feldstein and Marian Vaillant Wrobel, "Can State Taxes Redistribute Income?" *Journal of Public Economics*, Vol. 68, no. 3 (June 1998), pp. 369–96.

41 This effect could potentially be offset by the superior public services or facilities that can be financed by higher taxes, but this will not occur if the public benefits are dispersed across the population and not focused on the high-income taxpayers.

42 As long as all the provinces except Quebec participated in tax collection agreements with the federal government that required them to impose a "tax-on-tax," this limited the variation in their tax rate progressivity (except for provincial surtaxes) in a way that likely did not induce much interprovincial migration.

43 Canadian Alliance, "Tax Reduction *and* Tax Reform." Others active in the formulation of Alliance tax policy have also stated: "The first priority of the Alliance tax plan is to restore fairness to families"; Ken Boessenkool and Mark Mullins, "Not Just 'Single'-Minded," *Policy Options*, Vol. 21, no. 8 (October 2000), pp. 10-15.

44 Canadian Alliance, "Tax Reduction *and* Tax Reform," pp. 17, 22.

45 The study offers an example of one- and two-earner couples with the same total market earnings "assuming that both families have the same ability-to-pay …" Canadian Alliance, "Tax Reduction *and* Tax Reform," p. 25.

46 The psychic value includes the satisfactions of homemaking and any preference for minding one's own children rather than using paid childcare; the net income from working is after subtraction of daycare costs.

47 Kenneth J. Boessenkool and James B. Davies, *Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System*, Commentary No. 117 (Toronto: C.D. Howe Institute, November 1998), a study which also

provided some strong points favouring joint taxation; House of Commons, Standing Committee on Finance, Sub-Committee on Tax Equity for Canadian Families with Dependent Children, *For the Benefit of Our Children: Improving Tax Fairness*, Report 19 (Ottawa: June 1999); and Carole Vincent and Frances Woolley, "Taxing Canadian Families: What's Fair, What's Not," *Choices*, Vol. 6, no. 5 (Montreal: IRPP, July 2000), a study which also recognized household scale economies as a reason for some income-splitting provisions.

48 John Kenneth Galbraith, *Economics and the Public Purpose* (Boston: Houghton Mifflin, 1973), pp. 29–37.

49 This third factor would support some form of joint filing or income splitting but only under more restrictive conditions than the other cases. There are social benefits from parents staying home to nurture their children, and it may be apropos for tax policy to reward these benefits that are not part of a couple's own financial calculations.

50 The document cites four ways to solve the problem, but two appear to be very similar; and another method identified (joint filing using the same tax schedule as for single filers) is quickly dismissed as failing to achieve the horizontal equity objective. Canadian Alliance, "Tax Reduction *and* Tax Reform," p. 23.

51 Canadian Alliance, "Tax Reduction *and* Tax Reform," p. 23.

52 Even if the administration of the CTB were changed so as not to require reporting of spouses' incomes on tax returns, each spouse could still infer the other spouse's income from the amount of child benefits that were paid.

53 France allows full income splitting within the family even with children. The US allows only partial income splitting, the tax brackets for married joint returns are not twice as wide as the brackets for single filers. The first two tax brackets, which contain the great majority of filers, are 1.67 times as wide for married as for singles, and the top-tax bracket rate of 39.6 percent has the same income threshold for both types of returns (see Table 2). Also, note that joint filing was among the recommendations of the Carter Commission in 1966 that was not implemented in the sweeping Canadian tax reforms of 1972.

54 Recall the earlier analysis related to Figures 2 and 3.

55 The federal budget of 2000 announced the government's intention to raise the basic exemption to "at least $8,000" and the spousal/equivalent-to-spouse amount to "at least to $6,800" over the next five years. The existing differential could reflect either the existence of scale economies or the recognition of work-related expenses that do not arise for an at-home spouse.

56 The standard deduction is claimed by almost all filers at lower incomes; itemized deductions can be claimed in lieu of the standard deduction, but this is common only at middle and higher incomes. In addition, there is a personal exemption of US$2,800 per filer and dependant.

57 This provision is called a deduction, though it is like an exemption; regardless of the label, the amount is deducted from gross income to reach taxable income.

58 The income levels are $73,604 for one and two children and higher figures for households with more children; these are the levels at which the income-tested CTB payments are fully phased out.

59 One study finds that the employment of mothers while their children are younger (even controlling for family income) leads to long-run positive outcomes for the children in terms of their later high school graduation and job success. Robert H. Haveman and Barbara Schull

Wolfe, *Succeeding Generations: On the Effects of Investments in Children* (New York: Russell Sage Foundation, 1994).

60 Boessenkool and Davies, *Giving Mom and Dad a Break*; and Kenneth J. Boessenkool, "Putting Tax Policy in its Place: How Social Policy Took Over the Tax Treatment of the Family," in Douglas W. Allen and John Richards (eds.), *It Takes Two: The Family in Law and Finance* (Toronto: C.D. Howe Institute, 1999), pp. 138–39.

61 Finn Poschmann and John Richards, *How To Lower Taxes and Improve Social Policy*, Commentary No. 136 (Toronto: C.D. Howe Institute, February 2000).

62 Vincent and Woolley, "Taxing Canadian Families."

63 This element is common to several of the other proposals.

64 This proposal was first made in Jonathan R. Kesselman, "The Child Tax Benefit: Simple, Fair, Responsive?" *Canadian Public Policy*, Vol. 19, no. 2 (June 1993), pp. 109–32; it was further developed in Vincent and Woolley, "Taxing Canadian Families." The proposal in Poschmann and Richards, *How To Lower Taxes and Improve Social Policy*, has some formal similarities but would carry more complex administrative arrangements in integrating tax withholding and benefit systems.

65 Poschmann and Richards, *How To Lower Taxes and Improve Social Policy*, p. 7.

66 The Alliance analysis does acknowledge the existence of the very high MTRs resulting from the CTB phase-outs. "Tax Reduction *and* Tax Reform," p. 21.

67 For example, in BC, families with two children and incomes under $34,000 face a total clawback rate of 26 to 36 percent from the CTB, the BC Family Bonus, and GST credits; add to this the flat tax rate of 17 percent and a BC tax rate of about nine percent plus employee payroll taxes, and some will still face total MTRs above 60 percent.

68 This universal portion of the benefit could be set at the Alliance plan value of $510 per child or a higher figure.

69 This was first proposed in Kesselman, "The Child Tax Benefit," and developed further in Poschmann and Richards, *How To Lower Taxes and Improve Social Policy*.

70 Nicholas Rowe and Frances Woolley, "The Efficiency Case for Universality," *Canadian Journal of Economics*, Vol. 32, no. 3 (May 1999), pp. 613–29; and Nicholas Rowe and Frances Woolley, "The Benefits of Universality," *Policy Options*, Vol. 20, no. 5 (June 1999), pp. 57–60.

71 This situation mirrors a well-established proposition in public finance: it is inefficient to impose a distorting tax on an individual and give back the revenue collected as a lump-sum transfer. Universal benefits would be a lump-sum transfer for families above the income level where the CTB phase-outs ceased, and they would have to be financed by higher MTRs on all taxpayers at those income levels, including those receiving the new payments. Also see Jonathan R. Kesselman, "Reduce Income-Testing, Target Universal Benefits," *Policy Options*, Vol. 20, no. 10 (December 1999), pp. 21–22.

72 "A single low rate with significantly larger basic and spousal exemptions is the *simplest* way to reform Canada's tax system to eliminate the discrimination inherent within its present form" [emphasis added]. Canadian Alliance, "Tax Reduction *and* Tax Reform," p. 24.

73 The discussion in this section draws heavily on Kesselman, *Rate Structure and Personal Taxation*.

74 Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill, 1983); Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, CA: Hoover Institution Press, 1985). This proposal has been the basis of leg-

islative bills such as one by Congressman Dick Armey. It is claimed that this type of flat tax could be reduced to a postcard-sized tax return — surely an exaggeration.

75 David F. Bradford, *Untangling the Income Tax* (Cambridge, MA: Harvard University Press, 1986). This version of the tax requires that the flat rate of business tax be applied at the top personal MTR.

76 As already noted, the use of joint taxation for couples would equally well eliminate the incentives for shifting incomes between spouses. There remains the problem of preventing income and asset shifts to other relatives, especially dependent children.

77 The last vestiges of income averaging were phased out following the major Canadian tax reform of 1988; it was argued that the flatter tax rate schedules reduced the need for averaging provisions. RRSPs can be used for averaging in limited ways.

78 David J. Collins, "The Case Against Flat Rate Personal Income Taxation," in *Flat Rate Tax? Pros and Cons* (Sydney: The Taxation Institute Research and Education Trust, 1981), pp. 15-34, at p. 28.

79 The Alliance's "Frequently Asked Questions" about its flat tax plan state that "Reducing the tax code to a single rate means no more expensive accounting gymnastics to try and get into a lower tax bracket."

80 There are limits on interest deductions associated with claims made for the lifetime capital gains exemption (now defunct aside from small business and farming assets); this provision is called the cumulative net investment loss.

81 For further details on these issues, see Kesselman, *Rate Structure and Personal Taxation*.

82 The system described here is called a "credit income tax" (somewhat like a negative income tax) and was examined in detail in Jonathan R. Kesselman, "Taxpayer Behavior and the Design of a Credit Income Tax," in Irwin Garfinkel (ed.), *Income-Tested Transfer Programs: The Case For and Against* (New York: Academic Press, 1982), pp. 215–81.

83 However, if refundable tax credits such as the GST credits and Child Tax Benefits were retained, there would still be a need for widespread filing to obtain information on households' incomes. One solution to this would be to integrate these payments into the basic payments made in lieu of personal exemptions and deductions, the only constraint being that the phase-out rate on benefits would have to be combined with the flat tax rate and applied from the first dollar of income.

84 This last point may also explain why the Alliance chose to provide a separate child deduction rather than enrich and partially universalize the Child Tax Benefit.

85 For example, the Canadian Alliance study, "Tax Reduction *and* Tax Reform," p. 9, cites uncritically several studies that it purports to have found a significant negative impact of larger government on economic growth. These include an ideologically tainted study and two dated studies that have been controverted by more recent statistical studies (see citations in the next note).

86 Ross Levine and David Renelt, "A Sensitivity Analysis of Cross-Country Growth Regressions," *American Economic Review*, Vol. 82, no. 4 (September 1992), pp. 942–63; William Easterly and Sergio Rebelo, "Fiscal Policy and Economic Growth: An Empirical Investigation," *Journal of Monetary Economics*, Vol. 32 (December 1993), pp. 417–58; and Richard Kneller, Michael F. Bleaney and Norman Gemmell, "Fiscal Policy and Growth: Evidence from OECD

Countries," *Journal of Public Economics*, Vol. 74, no. 2 (November 1999), pp. 171–90.

87 Kneller, Bleaney and Gemmell, "Fiscal Policy and Growth," p. 188.

88 See Jonathan R. Kesselman, *General Payroll Taxes: Economics, Politics, and Design* (Toronto: Canadian Tax Foundation, 1997), chap. 3, for a critical review of this literature.

89 Although the cited study is dated and based on US estimates, it has the advantage of distinguishing taxes at the corporate and personal levels, which almost none of the other studies has done. For a recent but preliminary study of this topic for Canadian taxes, see W. Erwin Diewert and Denis A. Lawrence, "New Measures of the Excess Burden of Capital Taxation in Canada," mimeo (Vancouver: UBC Department of Economics, May 2000).

90 See Kesselman, *General Payroll Taxes*, pp. 39–41, for a graphical and intuitive explanation of the MEC concept.

91 Of course, the tax system can also inhibit investments in human capital through formal education or on-the-job training, but large public subsidies to education and the ability of firms to fully deduct their worker training costs from taxable income largely offset this bias.

92 For a comprehensive review of the literature, see Douglas B. Bernheim, "Taxation and Saving," in Alan J. Auerbach and Martin Feldstein (eds.), *Handbook of Public Economics*, Vol. 3 (Amsterdam: North-Holland, forthcoming).

93 See the extensive reviews of the labour supply literature in John Pencavel, "Labor Supply of Men: A Survey," in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, Vol. 1 (Amsterdam: Elsevier, 1986), pp. 3–102; Mark R. Killingsworth and James J. Heckman, "Female Labor Supply: A Survey," in Ashenfelter and Layard (eds.), *Handbook of Labor Economics*, pp. 103–204.

94 Nevertheless, in more technical economic terms, there can still be efficiency costs even if the quantity of hours supplied is little changed, on account of an income effect offsetting a pure substitution effect. This can explain the high MECs reported in the next paragraph for situations with fairly unresponsive labour supply.

95 The total annual allowable contributions to RPPs and RRSPs are 18 percent of earned income to a ceiling of $13,500 (with carry-over of unused room). This dollar ceiling is hit at $75,000 of annual earned income for those who save the full 18 percent.

96 Paul Beaudry and David Green, "What Is Driving U.S. and Canadian Wages: Exogenous Technical Change or Endogenous Choice of Technique?" *NBER Working Paper No. W6853* (Cambridge, MA: National Bureau of Economic Research, December 1998). In this theory, firms adopting "modern" technologies are relatively intensive in their usage of skilled labour and use capital more efficiently than the firms employing traditional technologies. Hence, the latter firms which use mostly unskilled labour are comparatively starved of capital when total savings are inadequate; conversely, they and their workers benefit disproportionately when capital becomes more abundant.

97 Canada, Department of Finance, *The Economic and Fiscal Update: Translating Better Finances into Better Lives* (Ottawa: Finance Department, November 2, 1999); Dale Orr and Bob Dugan, "The Economic Impact of the Reform Party's Proposals for Personal Income Tax Reductions,"(Ottawa, WEFA Inc., (January 2000), mimeo; and Dale Orr and Bob Dugan, "Economic and Fiscal Impact of Canadian Alliance Proposals

for Tax Reduction: Update," Ottawa, WEFA Inc. (September 2000), mimeo.

98 These figures and others in this section are taken from Orr and Dugan, "Economic and Fiscal Impact of Canadian Alliance Proposals for Tax Reduction," one of the two WEFA studies undertaken for the Canadian Alliance.

99 However, the latest fiscal analysis does not break out the revenue costs of the tax components individually.

100 For example, see Lawrence B. Lindsey, "Individual Taxpayer Response to Tax Cuts: 1982–1984," *Journal of Public Economics*, Vol. 33, no. 2 (July 1987), pp. 173–206; Martin S. Feldstein, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act," *Journal of Political Economy*, Vol. 103 (June 1995), pp. 551–72; Gerald Auten and Robert Carroll, "The Effect of Income Taxes on Household Incomes," *Review of Economics and Statistics*, Vol. 81 (November 1999), pp. 681–93; and Mary-Anne Sillamaa and Michael R. Veall, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1988 Tax Flattening in Canada," QSEP Research Reports no. 354 (Research Institute for Quantitative Studies in Economics and Demographics, McMaster University, 2000).

101 For example, see Joel Slemrod, "On the High-Income Laffer Curve," in Joel Slemrod (ed.), *Tax Progressivity and Income Inequality* (New York: Cambridge University Press, 1994), pp. 177–210; Alan J. Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986," *Journal of Economic Literature*, Vol. 35, no. 2 (June 1997), pp. 589–632; and Austan Goolsbee, "Evidence on the High-Income Laffer Curve from Six Decades of Tax Reform," *Brookings Papers on Economic Activity*, No. 2 (1999), pp. 1–47.

102 Orr and Dugan, "Economic and Fiscal Impact of Canadian Alliance Proposals for Tax Reduction," p. 16. The cumulative extra fiscal surplus for the five years ending 2005–06 is $47 billion.

103 Canadian Alliance website, "Frequently Asked Questions on Solution 17."

104 Canadian Alliance website, "Frequently Asked Questions on Solution 17."

105 Canadian Alliance, *A Time for Change*, p. 7.

106 Organisation for Economic Co-operation and Development, *Economic Outlook*, No. 65 (June 1999). These figures may overstate the cuts in that 1992 was near the low point of the business cycle.

107 See William B.P. Robson, Jack M. Mintz and Finn Poschmann, *Budgeting for Growth: Promoting Prosperity with Smart Fiscal Policy*, Commentary No. 134 (Toronto: C.D. Howe Institute: February 2000).

108 Jason Clemens and Fazil Mihlar, "The 20% Foreign Property Rule: Increasing Risk and Decreasing Returns on RRSPs and RPPs," *Critical Issues Bulletin* (Vancouver, BC: The Fraser Institute, April 1999); David Burgess and Joel Fried, "Canadian Retirement Savings Plans and the Foreign Property Rule," *Canadian Public Policy*, Vol. 25, no. 3 (September 1999), pp. 395–416; and Joel Fried and Ron Wirick, *Assessing the Foreign Property Rule: Regulation without Reason*, Commentary No. 133 (Toronto: C.D. Howe Institute, December 1999).

109 Statistics Canada, *Retirement Savings Through RPPs and RRSPs, 1991 to 1997*, Cat. No. 74F0002XIB (May 1999).

110 Although this point is not repeated in the 2000 federal budget, it appears in Report of the Standing Committee on Finance, *Budget 2000 — New Era ... New Plan* (Ottawa: December 1999), p. 75.

111 See Finn Poschmann, *Inflated Taxes, Deflated Paycheques*, Commentary No. 118 (Toronto: C.D. Howe Institute, December 1998).

112 The Canadian Alliance analysis at several points refers to the favourable efficiency aspects of payroll taxes that have a ceiling on taxable earnings, despite the fact that a ceiling necessitates a higher tax rate to raise the same revenues. "Tax Reduction and Tax Reform," pp. 28, 36, 45. For analysis of this, see Kesselman, *General Payroll Taxes*, pp. 240–41.

113 Canada, Department of Finance, *Budget 2000 — Budget Plan* (Ottawa: February 28, 2000), footnote 2 to Table 1.2, chap. 1.

114 Canada, Department of finance, *Budget 2000 — Budget Plan*, chap. 4.

115 These arguments have been made previously by Jonathan R. Kesselman, "Economics versus Politics in Canadian Payroll Tax Policies," *Canadian Public Policy*, Vol. 24, no. 3 (September 1998), pp. 381–87; for a somewhat contrasting view, see Jack M. Mintz and Finn Poschmann, *Tax Reform, Tax Reduction: The Missing Framework*, Commentary No. 121 (Toronto: C.D. Howe Institute, February 1999).

116 Canada, Department of Finance, *Report of the Technical Committee on Business Taxation* (Ottawa: 1998).

117 Jack M. Mintz, *Why Canada Must Undertake Business Tax Reform Soon, Backgrounder* (Toronto: C.D. Howe Institute, November 1999).

118 For an assessment of the Irish experience, see Brendan Walsh, "The Role of Tax Policy in Ireland's Economic Renaissance," *Canadian Tax Journal*, Vol. 48, no. 3 (2000), pp. 658–73.

119 The tax policy package presented in this section was completed by spring 1999 and draws on Jonathan Kesselman, "Tax Cuts for Growth and Fairness," *Policy Options*, Vol. 19, no. 10 (December 1998), pp. 13–16; Jonathan R. Kesselman, testimony before the House of Commons, Standing Committee on Finance, Meeting 180, April 29, 1999; Kesselman, "Base Reforms and Rate Cuts for a Revitalized Personal Tax"; Kesselman, "Economics versus Politics in Canadian Payroll Tax Policies"; Kesselman, "The Child Tax Benefit"; and Jonathan R. Kesselman, "Taxation of Capital Gains in Canada vs. the US," mimeo, prepared for the Fraser Institute first symposium on capital gains taxation, June 1999.

120 For more recent studies which advocate a similar tax strategy, see Pierre Fortin, "Less Taxes and Better Taxes: Principles for Tax Cuts and Tax Reforms," *Canadian Tax Journal*, Vol. 48, no. 1 (2000), pp. 92–100; and Jack M. Mintz, "Reforming the Tax Cut Agenda," *Canadian Tax Journal*, Vol. 48, no. 3 (2000), pp. 689–709.

121 The former two figures were the estimates given in the original plan, and the final parameter values for these taxes are the same in the revised Alliance plan. The $26 billion figure given for the personal tax cuts takes the original flat tax estimate of $29.2 billion and reduces it by our estimate of $2.4 billion for the switch to the dual tax if applied in 2000 with some growth for the five years. Note that the revised fiscal analysis done for the Canadian Alliance by WEFA Inc. does not detail revenue costs of the major tax components separately, unlike the first analysis. Relative to the tax changes in the 2000 budget, the Alliance tax cuts are much less costly; for example, there is no revenue cost for the corporate tax cuts given that the same cuts are promised in the budget.

122 The age credit is already phased out with income over moderate- to middle-income levels, but the issue here is one of horizontal rather than vertical equity. Economic evidence suggests that seniors typically face lower household expenses (food, transport, entertainment, etc.) than non-aged households to reach the same living standard for a given income;

horizontal equity would thus support a lower credit level for seniors than others. An earlier rationale for the age credit was to prevent seniors receiving GIS benefits from being taxable as well, but there is already an overlap.

123 It might be simpler to introduce a provision for the transfer of taxable incomes (possibly limited in amounts) between spouses rather than introduce a separate rate schedule for married filers.

124 Don Drummond, "Show Us the Money," *The Globe and Mail*, July 18, 2000. His illustrative tax schedule is 17 percent on the first $30,000, 23 percent on $30,000 to $70,000, 26 percent on $70,000 to $125,000, and 29 percent above that.

125 Of course, all schemes would also cut the MTRs most — by 17 percentage points — for those individuals who became non-taxable as result of the increased taxable thresholds.

126 For analysis of this issue in the BC context, see Jonathan R. Kesselman, "Provincial Tax Policies in the New Economy: The Case of British Columbia," *Canadian Business Economics*, Vol. 4, no. 1 (October-December 1995), pp. 24–46.

127 For a detailed analysis and assessment of TPSPs, see Jonathan R. Kesselman and Finn Poschmann, *A New Option for Retirement Savings — TPSPs* (April 2000); forthcoming as a C.D. Howe Institute Commentary.

128 For this proposal and analysis as well as comparisons of Canadian and US capital gains practices, see Kesselman, "Taxation of Capital Gains in Canada vs. the US."

129 The Alliance analysis states that "three quarters of capital gains will still be included in taxable income..." See Canadian Alliance, "Tax Reduction *and* Tax Reform," p. 44.

130 This change was announced in "Notes for Address by Stockwell Day to the Greater Nepean Chamber of Commerce," June 7, 2000; posted at the website *www.stockwellday.com*.

131 This change was also advocated by the Mintz Committee; see *Report of the Technical Committee on Business Taxation*. Note that a rollover into RRSPs may be overly harsh treatment if there is no deduction for the amounts contributed. If such a rolled-over gain were quickly withdrawn from the RRSP, it would be fully taxable and would not even enjoy capital gains treatment.

132 Without a balance in the taxation of dividends and capital gains, it becomes essential to apply complex tax measures to prevent tax avoidance. See Jack M. Mintz and Thomas A. Wilson, *Capitalizing on Cuts to Capital Gains Taxes*, Commentary No. 137 (Toronto: C.D. Howe Institute, February 2000).

133 For analysis of this issue, see A. Pierre Cloutier and Bernard Fortin, "Converting Exemptions and Deductions into Credits: An Economic Assessment," in Jack Mintz and John Whalley (eds.), *The Economic Impacts of Tax Reform* (Toronto: Canadian Tax Foundation, 1989), pp. 45–82.

134 For a fuller justification of each item cited here, see Kesselman, "Base Reforms and Rate Cuts for a Revitalized Personal Tax." Note that, with taxability of employer-paid health benefits, many of the medical and dental care expenses would be allowed as tax deductions subject to an income-related threshold.

135 The premiums that finance workers' compensation benefits are paid by employers and not counted as a taxable benefit for employees, so it is appropriate for the benefits to be taxable.

136 House of Commons, Standing Committee on Finance, *Productivity with a Purpose: Improving the Standard of Living of Canadians*, Report 20 (Ottawa: June 1999), pp. 30–31, 41, 46; House of Commons, Standing Committee on

Finance, *Budget 2000: New Era ... New Plan*, Report 1 (Ottawa: December 1999), chap. 2 and pp. 174–75; also see House of Commons, Standing Committee on Industry, *Productivity and Innovation: A Competitive and Prosperous Canada* (Ottawa: April 2000), chap. 9; and House of Commons, Finance Sub-Committee, *For the Benefit of Our Children*.

137 Progressive Conservative Party of Canada, *Task Force on Taxation, Report of the Task Force: Creating a Culture of Opportunity* (Ottawa: February 2000). The Conservatives' election platform, released after this study was completed, abandoned all of the cuts to personal tax rates and expanded brackets proposed in its task force report (as shown in Table 17). It retained the pledge to raise the basic and spousal exemptions to $12,000 over five years but halved the proposed child deduction to $1,176. It also retained the pledge to abolish at once taxes on capital gains, but it dropped the earlier suggested increase in RPP/RRSP contribution limits. Progressive Conservative Party of Canada, *Change You Can Trust — The Progressive Conservative Plan for Canada's Future*, October 25, 2000.

138 Alberta Treasury, *Budget 2000 Backgrounder: Alberta's Tax Reforms Simplify System and Leave More Money in Taxpayers' Pockets*, states: "The new system reduces the differences in Alberta taxes paid by single- and two-income families. Today, a single-income family pays more in personal income taxes than a family at the same income level with two parents working outside the home. Under the new system, both types of families will see their taxes go down. But the single-income families — which includes single parents — will see their taxes go down more."

139 Even with the existing exemption levels and tax rates, no poor household of any composition (single adult, single parent, or couple with no, one, two, or three children) faces a basic federal MTR higher than 17 percent.

140 There would be a small range at low incomes where the jurisdictions had differing tax thresholds and only the federal 17 percent rate would apply.

141 Canada, Department of Finance, *Economic Statement and Budget Update* (Ottawa: October 18, 2000).

142 "[W]e will not bring in the 17 per cent flat tax. We will not bring it in tomorrow and we will not bring it five years from now. It is untried and it is unfair...It is unfair even under the 17-25 interim flat tax plan..." Canada, Department of Finance, *Economic Statement and Budget Update*, p. 16.

143 This additional $42 billion was made up of $34.8 billion directly resulting from mini-budget tax changes plus another $7.4 billion from increases in the implied tax cuts stemming from the revised economic forecasts. Canada, Department of Finance, *Economic Statement and Budget Update*, p. 97.

144 The $66 billion figure is not exactly comparable as it is for the five-year period ending in 2005–06 and also does not include the Alliance's later inclusion of tax cuts for motor fuels. Orr and Dugan, "Economic and Fiscal Impact of Canadian Alliance Proposals for Tax Reduction."

145 There are substantial increases, though, in the credits for caregivers, disabled persons, and full-time students in post-secondary education.

146 Interestingly, the mini-budget's one-time relief for high home heating costs, with a revenue cost of $1.3 billion, will be delivered through the tax system to all individuals and families eligible for the GST credit based on their 2000 tax returns. The full $125 and $250 relief will be paid to individuals and families, respectively.

without a phase-out based on income. While this avoids raising the effective MTRs, it does introduce a perverse inequity in which a household whose income was just one dollar too high to get the GST credit will lose the full amount of the fuel rebate. If this provision were repeated in future years, it would obviously raise the perceived MTR.

147 Note that the mini-budget changes embody no flattening of the overall tax schedule if judged by the ratio between top and bottom MTRs. This ratio is 1.791 in 2000 (30.45 percent including surtax, divided by 17 percent) and rises slightly to 1.813 in 2001 (29/16).

148 The mini-budget also enlarges a provision for tax-free rollovers of capital gains for small business investments. It further extends the new one-half tax exclusion for capital gains to the treatment of employee stock options.

149 Canada, Department of Finance, *Economic Statement and Budget Update* (2000), p. 159.

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